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Defining Legitimate Competition: How to Clarify Pricing Abuses Under Article 82 EC

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Defining Legitimate Competition: How to Clarify Pricing Abuses Under Article 82 EC

John Temple Lang and Robert O'Donoghue

Abstract

This Article discusses the principles under Article 82 of the Treaty Establishing the European Community concerning anticompetitive or exclusionary abuses involving pricing issues. This Article is structured as follows. Part I outlines the basic economic thinking behind price discrimination and identifies the principal legal situations under Article 82 in which it arises. Discriminatory pricing should only be prohibited (and therefore needs to be justified) in a small number of situations. Parts II-III discuss the specific situations under Community competition law in which price discrimination and the legality of pricing practices may be relevant. Part II discusses rebate and discounting practices, including target (or sales growth) rebates, fidelity or loyalty rebates, and rebates in return for exclusivity. Part III discusses price discrimination that gives rise to distortions of competition between customers. This concerns Article 82(c), a provision that has some parallels with the Robinson-Patman Act under U.S. law. In practice, it will be rare that a profit-maximizing firm will have the ability or incentive to charge different prices to comparable customers to such an extent that competition between those customers will be significantly distorted. Part IV discusses predatory pricing. It is important that prices that remain above average variable cost should nearly always be treated as legal, since rivals will usually be able, and should be encouraged, to compete in that scenario. Community competition law should only treat pricing above average variable cost as unlawful where there is evidence of other abusive behavior linked to that low pricing, in other words a clear plan to eliminate a rival by using a range of illicit practices. Part V discusses a specific instance of predatory pricing—cross-subsidization. Cross-subsidy cases are in essence cases in which the abuse, if there is one, is predatory pricing. Finally, the Conclusion summarizes the author's comprehension of what the correct principles under Community competition law concerning pricing practices should be.

ARTICLES

DEFINING LEGITIMATE COMPETITION: HOW TO CLARIFY PRICING ABUSES UNDER ARTICLE 82 EC

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"Whether any particular act of a monopolist is exclusionary, rather than merely a form of vigorous competition, can be difficult to discern: the means of illicit exclusion, like the means of legitimate competition, are myriad. The challenge for an antitrust court lies in stating a general rule for distinguishing between exclusionary acts, which reduce social welfare, and competitive acts, which increase it."¹

INTRODUCTION

The above statement neatly encapsulates one of the most difficult issues in antitrust law: how do you have clear rules that distinguish between legitimate and unlawful conduct? Nowhere are these problems more acute than in the area of pricing behavior. The basic question is an apparently simple one: how should antitrust law draw the line between legitimate and desirable price competition, on the one hand, and undesirable and unlawful price competition, on the other? It is important that this balance is correctly struck: the welfare cost and chilling effect of discouraging legitimate price competition is considerable; the cost of allowing unlawful pricing to go unchecked may be no less serious.

Although a now universally-accepted distinction is drawn in the European Community ("Community") competition law between exploitative and exclusionary (or anticompetitive)

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1. *United States v. Microsoft*, 253 F.3d 34, 58 (D.C. Cir. 2001).

abuses,² very little effort has been made to clarify the general principles about the kinds of behavior that are contrary to Article 82 of the Treaty Establishing the European Community ("Article 82") which prohibits abuse of a dominant position. The case law and practice has arisen pragmatically, and largely in response to complaints to the European Commission and appeals to the Community Courts against Commission decisions adopted on the basis of such complaints. With the exception of specialized Notices and guidance in the telecommunications and postal sectors, the Commission has not attempted to develop any kind of general or comprehensive statement on abusive behavior. There have been several consequences of this unplanned growth. First, the Commission and the Community Courts have dealt with individual cases that were said to raise questions of abuse by reference to the facts of the individual case, seemingly without having any clear general analytical or intellectual framework for doing so. Second, a number of basic questions have not been answered or even discussed, because due to the accidents of litigation or otherwise, they did not arise in any of the cases that have been decided. Finally, the influence that economic thinking has had on the Community rules on distribution, horizontal agreements, and mergers has not been felt, to the same extent or at all, in the interpretation and application of Article 82.

This Article discusses the principles under Article 82 concerning anticompetitive or exclusionary abuses involving pricing issues. Pricing cases have been chosen for several reasons. First, a fundamental goal of Community competition law is to encourage price competition, including price competition from dominant firms.³ Second, pricing practices are relevant to every

2. See BELLAMY & CHILD, *EUROPEAN COMMUNITY LAW OF COMPETITION* 5TH ED. sec. 9-072 (P.M. Roth QC ed., 2001); see also John Temple Lang, *Abuse of Dominant Positions in European Community Law, Present and Future: Some Aspects*, in *FIFTH ANNUAL FORDHAM CORP. L. INST.* 41-55 (Barry Hawk ed., 1978).

3. In *Compagnie Maritime Belge Transports SA and others v. Comm'n and others*, Joined Cases C-395/96 P and C-396/96 P, [2000] E.C.R. I-1365, Advocate General Fennelly explained the role of price competition in Community law as follows:

Price competition is the essence of the free and open competition which it is the objective of Community policy to establish on the internal market. It favors more efficient firms and it is for the benefit of consumers both in the short and the long run. Dominant firms not only have the right but should be encouraged to compete on price.

Id. at I-1411, para. 117. "Community competition law should . . . not offer less efficient

company that is, or may be, dominant: every company has to have a pricing policy, and needs to know what the constraints on its policy may be. Third, because low prices nearly always benefit consumers, any antitrust objections to them should be looked at critically to ensure that the rules are clear and no more than necessary in the circumstances. If the rules are not clear or they are too restrictive, there is a significant risk that legal advisers will be tempted to give overcautious advice. This in turn could lead to a chilling of desirable price competition, with potentially significant welfare implications. Fourth, it is on pricing issues that the Commission seems most clearly to have gotten away from both sound economics and good law. A number of Commission statements on pricing practices come perilously close to stating *per se* rules against certain forms of pricing behavior. Other statements are liable to be taken out of context and give rise to confusion. It is on pricing issues that the Commission is most obviously running the risk of discouraging legitimate and desirable competition. It is on pricing issues that a clear and comprehensive statement of the legal and economic principles is most urgently needed, not only to guide the thinking of the Commission, companies, and their lawyers, but also for the guidance of national competition authorities which are intended, under the Commission's proposals for decentralization of Community competition law, to apply Article 82 more than they have in the past. Lastly, pricing issues involve some of the more significant differences between U.S. and European Union ("EU") antitrust law, and these should be minimized where possible.

This Article is structured as follows. Part I outlines the basic economic thinking behind price discrimination and identifies the principal legal situations under Article 82 in which it arises. The freedom of a dominant company under Community competition law to charge different prices for the same product or service has given rise to much discussion, and in our view to unnecessary confusion. There is no general principle that a dominant company must not charge different prices for the same product or service. We argue that discriminatory pricing should only be prohibited (and therefore needs to be justified) in a small number of situations. First, where a dominant company's offering of

undertakings a safe haven against vigorous competition even from dominant undertakings." *Id.* at I-1418, para. 132.

different prices to customers distorts competition in a meaningful way between those customers. This is a "secondary-line" abuse contrary to Article 82(c). Second, price discrimination may require justification where it leads to the unlawful exclusion of rivals, contrary to Article 82(b). This broad category of "primary line" abuses covers predatory pricing and a range of other pricing practices that may give rise to exclusion concerns. Price discrimination may also be relevant in another situation, that is where a vertically-integrated dominant firm applies less favorable terms to companies that it supplies but that also compete with its downstream business. This mainly concerns situations resembling essential facilities and is not discussed here. In each of these situations of price discrimination, we argue that the principles of law and economics that apply are different, the anti-competitive effects which the law is intended to prevent are different, and the defenses which may be relevant are different. But outside of these specific situations, Community competition law should make clear that different prices may be freely charged, and no defense is needed. This is an important conclusion, because it frees dominant companies from unnecessary and anticompetitive constraints on legitimate competition, and clarifies the legal analysis.

Parts II-III discuss the specific situations under Community competition law in which price discrimination and the legality of pricing practices may be relevant. Part II discusses rebate and discounting practices, including target (or sales growth) rebates, fidelity or loyalty rebates, and rebates in return for exclusivity. It is perhaps in regard to these practices that certain Commission statements appear to deviate most from established economic thinking. In a number of cases, the Commission has made statements that seem to establish *per se* rules against the use by dominant firms of these types of normal commercial practices. We argue that Community competition law on discounting proceeds from the wrong premise. If the price is not predatory, it should benefit from a very strong presumption of legality, since it will generally be pro-competitive and based on efficiencies. The situation should only be different where the conditions attached to obtaining the favorable price are anticompetitive. The basic antitrust question is whether the customer would have to agree to an anticompetitive condition, that is to buy exclusively or almost exclusively from the dominant firm, to obtain the most favorable

discount. These cases raise difficult issues and involve consideration of a wide range of factual elements concerning the market context and foreclosure effect of the rebate in question. However, we argue that some basic distinctions are clear. If the rebate is not individually negotiated with the customer, it will usually be simply a list price or a generally applicable volume discount that should be regarded as unobjectionable. If the rebate is individually negotiated, we argue that real issues only arise if it leads to exclusive or near-exclusive purchasing in circumstances liable to have a material adverse effect. The availability of a number of defenses should also be considered. The important question we address is how Community competition law should distinguish between price reductions constructed to oblige buyers to buy exclusively from a dominant supplier, on the one hand, and price reductions legitimately constructed to enable buyers to get the best price for the maximum quantity they wish to purchase, on the other.

Part III discusses price discrimination that gives rise to distortions of competition between customers. This concerns Article 82(c), a provision that has some parallels with the Robinson-Patman Act under U.S. law. We argue that, in practice, it will be rare that a profit-maximizing firm will have the ability or incentive to charge different prices to comparable customers to such an extent that competition between those customers will be significantly distorted. Moreover, in many cases, valid defenses will be available to justify those price differences. This means that the only clearly identifiable situation under Community competition law in which the non-discrimination principle would apply and none of the valid defenses would be available is likely to be where a State-owned or controlled company charges different prices to domestic and foreign buyers for protectionist reasons. In most other situations, a dominant firm will have no incentive to treat similarly-situated buyers so differently.

Part IV discusses predatory pricing. As in the United States, this topic has given rise to much discussion in the EU, but very few cases in which a successful claim has prevailed. In over forty years of Community competition law, there have only been three instances in which a dominant firm's prices have been found to be predatory. In general, Community competition law's approach to predatory pricing seems reasonable. However, there are several cases under Community competition law that have

treated pricing above average variable cost (and even pricing above average total cost) as exclusionary. These cases are problematic because neither the Commission nor Community Courts have developed a clear analytical framework to explain how price-cutting that remains above cost harms consumers. We argue that it is important that prices that remain above average variable cost should nearly always be treated as legal, since rivals will usually be able, and should be encouraged, to compete in that scenario. Our conclusion is that Community competition law should only treat pricing above average variable cost as unlawful where there is evidence of other abusive behavior linked to that low pricing, in other words a clear plan to eliminate a rival by using a range of illicit practices.

Part V discusses a specific instance of predatory pricing — cross-subsidization. We argue that cross-subsidy cases are in essence cases in which the abuse, if there is one, is predatory pricing. There is no abuse of cross-subsidizing in the absence of predatory prices, since a price that is above cost does not, by definition, need a subsidy. We also consider what costs must be taken into account in that situation to determine whether the lower price is predatory, and in particular, the issue of allocation of common costs between a competitive and a monopoly market in the light of the Commission's recent *Deutsche Post* decision.

Finally, the Conclusion summarizes what we believe should be the correct principles under Community competition law concerning pricing practices.

I. *PRICE DISCRIMINATION UNDER COMMUNITY COMPETITION LAW*

A. *Some Basic Economic Concepts*

Discriminatory pricing is a broad term that covers a range of situations in which a company charges different prices for the same product to similarly-situated customers. Distinguishing between desirable and undesirable price discrimination lies at the heart of the underlying welfare objectives of antitrust law. The economics of price discrimination are complicated, but may be briefly summarized as follows.⁴ As a basic premise, economists

4. Derek Ridyard, *Exclusionary Pricing and Price Discrimination Abuses Under Article 82 – an Economic Analysis*, EUR. COMPETITION L. REV. 2002, 23(6), 286-303, has produced a

consider that marginal pricing — pricing at the level of the extra cost of producing the last unit of production — maximizes consumer welfare. This creates problems for industries (of which there are many) that have high fixed costs and need to recover as much of those costs as possible in order to survive in the long-term. There is also an additional problem in many “new economy” industries where marginal costs are very low, but research and development and innovation costs are high. In these situations, it makes sense that a company may wish to price above marginal cost in order to recover some fixed costs for those who are willing to pay more and at or near marginal cost for those who can only afford to pay less but might not otherwise be able to afford the product or service in question. So if marginal costs are, say, 10% of the list price and there is a customer who is unwilling or unable to pay more than 50% of the list price for the product, it is in the interests of both, the customer and the dominant company to grant the 50% discount. The dominant company gets a significant positive contribution to its revenues from the sale. The customer gets a product, which it could not otherwise afford. The transaction is economically rational and pro-competitive, and it would harm both parties to prohibit it. In other words, economists do not tend to view price discrimination with any particular suspicion, but think that its effects may be benign or at least not obviously anticompetitive.

B. *Price Discrimination Under Article 82*

Despite much discussion of price discrimination in the decisional practice of the Commission and the case law of the Community Courts, it is worth recalling that the only provision of the Treaty Establishing the European Community (the “EC Treaty”) that prohibits discrimination is Article 82(c), which prevents dominant companies from “applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage.”⁵ However, the list of

good summary of the basic economic principles, and a useful criticism of the lack of economic rigor in some recent Commission decisions on pricing under Article 82.

5. Consolidated version of the Treaty establishing the European Community, art. 82(c), O.J. C 340/3, at 209 (1997), 37 I.L.M. 79 at 71 (ex art. 86) [hereinafter Consolidated EC Treaty], *incorporating changes made by* Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts, Oct. 2, 1997, O.J. C 340/1 (1997) (amending Treaty on European

abuses in Article 82 is not exhaustive,⁶ and at least four clear situations of discrimination can be distinguished:

- Where the dominant enterprise is selling to companies not otherwise associated with it, and the companies are in competition with one another. In this situation, it can be an abuse if the difference in treatment is big enough to create a competitive disadvantage for the companies subject to the higher price or the less favorable treatment. This is the situation envisaged by Article 82(c). It is a “secondary line” abuse and is discussed in Part III;
- Where the dominant enterprise is treating customers differently on the basis of their nationality. Discrimination on the grounds of nationality is outlawed generally by the EC Treaty and such behavior is unlawful under Article 82(c). This is also a secondary line abuse and is discussed in Part III;
- Where the dominant enterprise discriminates in the terms and conditions and prices that it offers in such a way that leads to the unlawful exclusion of rivals. In this situation, the clause in Article 82 that is primarily applicable is Article 82(b) which prohibits “limiting production, markets, or technical development to the prejudice of consumers.”⁷ A dominant enterprise is prohibited by this clause from limiting the production, marketing or technical development of its competitors, as well as its own.⁸ This is a “primary line” abuse. In practice, discrimination in this sense is most likely to occur in two situations. First, where a dominant firm makes a price reduction conditional on the buyer’s making all or nearly all of its purchases of the product in question from the dominant

Union (“TEU”), Treaty establishing the European Community (“EC Treaty”), Treaty establishing the European Coal and Steel Community, and Treaty establishing the European Atomic Energy Community and renumbering articles of TEU and EC Treaty).

6. See *Compagnie Maritime Belge*, [2000] E.C.R. at I-1475, para. 112.

7. Consolidated EC Treaty, *supra* n.5, art. 82(b), O.J. C 340/3, at 209 (1997), 37 I.L.M. at 71 (ex art. 86).

8. See *Coöperative vereniging ‘Suiker Unie’ UA and others v. Comm’n*, Joined Cases 40-48, 50, 54-56, 111, 113-14/73, [1975] E.C.R. 1663; *Radio Telefis Eireann (RTE) and Independent Television Publication Ltd. (ITP) v. Comm’n*, Joined Cases C-241/91 P & C-242/91 P, [1995] E.C.R. I-743; *Klaus Höfner and Fritz Elser v. Macrotron GmbH*, Case C-41/90, [1991] E.C.R. I-1979; Non-contentious proceedings brought by *Job Centre Coop. arl*, Case C-55/96, [1997] E.C.R. I-7119.

enterprise. If this kind of abuse is in question, it is the condition on which the price reduction is given which is exclusionary, not the price reduction itself. This situation is discussed in Part II. Second, where there is predatory pricing in the broad sense. This situation is discussed in Part IV; and

- Where a vertically integrated dominant enterprise's "upstream" activities (e.g., selling an important raw material or other input) discriminate in favor of the dominant enterprise's own downstream activities, and against its competitors in the downstream market, in the terms on which it supplies the raw material or input. The rule is strict, so that if the difference in treatment has any economic significance, there is no need to prove that the downstream competitors are suffering any special competitive disadvantage. Since this situation mainly deals with situations resembling essential facilities rather than pricing issues, it will not be discussed in this Article.

There are several reasons for distinguishing between these categories. First, there are differences in the strictness of the applicable rules in each case. Second, a case can only be analyzed correctly when it is clear into which of these categories it may fall. Finally, different kinds of defenses apply for each of the different categories of abuse.

II. DISCOUNTING AND REBATE PRACTICES

Companies rely on a range of different pricing and discounting practices to capture market share and retain the business of existing customers. These include "loyalty" or "fidelity" rebates, target (or market share growth) rebates, and similar incentives. Such practices are common in many industries and are an essential competitive tool in many others. There is no obvious reason why antitrust law should view such practices with any particular suspicion, since they typically lead to lower prices, which should in nearly all cases benefit from strong presumptions of legality. Leaving aside issues of bundling and tying, the situation might be different in only two instances: first, where the lower price is predatory; and second, where the lower price is conditional on the customer purchasing all or nearly all of its requirements from the dominant firm. These objections are dif-

ferent; in one case it is the price that is the problem; in the other it is the exclusionary conditions attached to the favorable price. This section discusses discounts that exclude competitors by making discounts dependent on the customer's buying exclusively or almost exclusively from the dominant firm. (Predatory pricing is discussed in Part IV.)

Community competition law takes the view that rebates that are conditional on a customer's purchasing all or a large part of its requirements from a dominant firm may be abusive. In other words, it recognizes that the conditions attached to the price may be unlawful. While this is not universally accepted as correct, it has some doctrinal basis⁹ and is not obviously wrong.¹⁰ However, the difficulty is that a number of recent Commission statements seem to suggest a general rule that *any* discount that is conditional on, or simply creates incentives for, a customer's buying *some* of its requirements from a dominant company is abusive. Other Commission statements suggest that no discount can be offered by a dominant firm unless justified by cost savings

9. See Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615-39 (2000). While there is some agreement under U.S. law that rebates conditional on exclusive purchasing may, absent clear efficiencies, be unlawful, there has been little if any judicial endorsement of a similar analysis for rebates conditional on a customer's purchasing a large part of its requirements from a dominant firm. Instead, the U.S. courts have tended to examine whether the discounted price is predatory; if it is not, it is simply a lower price that competitors should be free to match in the absence of an exclusive dealing requirement or a discount that is conditional on exclusive dealing. Thus, in *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000), the 8th Circuit sanctioned a discount plan in which discount levels increased along with the market-share percentage purchased from the seller. The Court found that the discounts were above cost; only a single product was involved; the rival sellers offered similar discounts; and the ease of market entry precluded anticompetitive results from the discounting, as a new firm could enter the market and challenge the prices offered by the dominant firm. In general, U.S. plaintiffs have not been successful in challenging incentive schemes. See *FLM Collision Parts, Inc. v. Ford Motor Co.*, 543 F.2d 1019 (2d Cir. 1976); *Western Parcel Express v. United Parcel Service of America, Inc.*, 190 F.3d 974 (9th Cir. 1999); *Virgin Atlantic Airways Limited v. British Airways plc*, 257 F.3d 256 (2d Cir. 2001), and *LePage's Incorporated v. 3M (Minnesota Mining and Manufacturing Company)*, 2002 WL 46961 (3d Cir. 2002). In *SmithKline Corp. v. Eli Lilly and Co.*, 575 F.2d 1056 (3d Cir. 1978), the plaintiff was successful, but that was on the basis of discounts that were conditional on tied sales.

10. There is no obvious analytical reason why a discount conditional on a customer's purchasing, say, 95% of its requirements (assuming they are known to the dominant company) should be treated differently from a requirement to buy exclusively to obtain the discount. This means that there is a legitimate basis for analyzing such cases under exclusive dealing principles.

or some other objective reason. The Commission has also said that any practice aimed at increasing a dominant firm's market share may be unlawful. These statements cannot be right. Set forth below is a synopsis of the existing law (Section A) and available defenses (Section B), followed by certain comments that seek to clarify that law (Section C).

A. *Community Law on Discounts and Rebates*

Apart from predatory pricing, the Commission and Courts have identified three main categories of discounting practices that may be found abusive under Article 82: (1) rebates conditional on exclusive purchasing; (2) loyalty rebates; and (3) target rebates.

1. Rebates In Return For Exclusive Purchasing

Rebates granted by a dominant supplier on the condition that a customer purchase its requirements for the relevant products exclusively from that supplier have generally been found abusive.

In *Suiker Unie*, for example, the Court of Justice found that the potential loss of the challenged rebate created an overwhelming incentive for customers who would otherwise have considered purchasing some of their needs from other suppliers to deal with the dominant company. If a customer made one purchase from a competitor of the dominant supplier, the customer lost the entire rebate on all its purchases from the dominant supplier over an entire year. The Court of Justice found that this system placed customers who also bought sugar from other sources at an unjustifiable disadvantage, enabling the dominant supplier to "control" the amount of sugar that its customers bought from foreign producers. Since its customers all depended at least in part on *Suiker Unie's* deliveries (as customers' storage facilities were inadequate and they needed regular supplies), the disadvantage of losing a rebate applicable to an entire year's purchases would have outweighed any advantage gained by buying some sugar from third parties even if such purchases could be made at more favorable prices. No competitor could sell one consignment at a price that gave the buyer a cost saving equal to the lost rebate on a year's purchases from the dominant supplier. As a result, the rebate gave other pro-

ducers no chance of competing with the association, foreclosing them from the market.¹¹

2. Loyalty Rebates

In *Hoffmann-La Roche*, the Court of Justice condemned a “loyalty” or “fidelity” rebate, that is to say “discounts conditional on the customer’s obtaining all or most of its requirements . . . from the undertaking in a dominant position.”¹² Roche had offered different customers different prices for identical quantities of the same product, depending on whether or not they agreed to limit purchases from its competitors. The Court examined whether the system had in fact foreclosed rivals from the market and found that it had done so:

The fact of agreeing with purchasers that they will buy all or a very large proportion of their requirements from only one source . . . removes all freedom of choice from purchasers in their selection of sources of supply, and ties them to one supplier. The special price offered by Roche is the consideration for the abandonment by its purchasers of their opportunities to obtain substantial proportions of their requirements from competitors. Should a purchaser not observe his obligation of exclusivity — by purchasing some of his requirements from another vitamin manufacturer — the fidelity rebate is forfeited not only in respect of the amount of such purchase, but in respect of all his purchases from Roche.¹³

The Court found further that this rebate system had not evolved out of legitimate efforts by the dominant firm to increase its sales, but were rather motivated by specific exclusionary intent. The rebates were: “designed to deprive the purchaser of or restrict his possible choices of sources of supply and to deny other producers access to the market,” “intended to give the purchaser an incentive to obtain his supplies exclusively from the undertaking in a dominant position,” and “designed through the grant of a financial advantage to prevent customers from obtaining their supplies from competing producers.”¹⁴

11. See *Suiker Unie*, [1975] E.C.R. 2001-04, paras. 502-26.

12. See *Hoffman-La Roche & Co. AG v. Comm’n*, Case 85/76, [1979] E.C.R. 461, at 540, para. 89.

13. *Id.* at 467, para. 24. The Commission reached a similar conclusion in its decision. See *Hoffman-La Roche Decision*, O.J. L 258, at 514, paras. 22 and 24 (1997).

14. *Id.* at 540, para. 90.

The Court followed the same line of reasoning in *Irish Sugar*, where the dominant supplier's fidelity rebate was conditional on the customer's purchasing "all or a large proportion" of its retail sugar requirements from it.¹⁵ The Court found that the rebate had foreclosed competitors from the market:

The fact that ADM [a customer] previously obtained its supplies from SDL [Irish Sugar's distributor] before being canvassed by ASI [Irish Sugar's competitor] confirms that the granting of that rebate . . . had the effect of tying the customer to the supplier in a dominant position or, in other words, of recovering a customer who was inclined to switch to the competition.¹⁶

Moreover, the Court found that the rebates formed part of a plan designed specifically to exclude Irish Sugar's competitor:

[The] approach to ADM took place in the context of a strategy devised jointly by [Irish Sugar and its distributor] to prevent the expansion of the Eurolux brand on the Irish retail market by ensuring the fidelity of its customers.¹⁷

The Commission's decision in *Soda-ash/Solvay* was based on similar reasoning. Solvay had adopted a pricing structure under which it offered customers a standard list price on a basic contractual tonnage amount (usually calculated to represent around 80% of the customer's total annual requirements), and payments and discounts for marginal purchases above the basic amount (the "top slice," for which the customer had potential alternative sources). The top-slice rebate was only given where Solvay was the customer's sole or principal supplier.¹⁸ The Commission found that this rebate scheme made it:

difficult or impossible for an existing or potential supplier to enter as second supplier for the marginal tonnage, since in order to match the substantial pecuniary advantages offered by Solvay and obtain the order for the top 'tranche' of business, they would have to sell at unprofitable or at 'dumping'

15. *Irish Sugar plc v. Comm'n*, Case T-228/97, [1999] E.C.R. II-2969, at II-3049, para. 194. See also Commission Decision No. 97/624/EC, O.J. L 258/1 (1997) [hereinafter *Irish Sugar Decision*].

16. *Irish Sugar*, [1999] E.C.R. II-3051, para. 198.

17. *Id.*

18. See Commission Decision No. 91/299/EEC, O.J. L 152/21, at 24, para. 16 (1991) ("*Soda-ash/Solvay Decision*").

prices.¹⁹

Solvay argued that the system was justified, since it simply represented volume discounts that depended on customers reaching objective and pre-determined purchase thresholds. However, in view of Solvay's position as *de facto* exclusive supplier to most customers and the substantial documentary evidence that: (1) the system was "specifically intended to ensure the loyalty of the customer and exclude or limit competition,"²⁰ and (2) the whole purpose of the rebates was "to remove or restrict the opportunity of other producers or suppliers of Soda-ash to compete effectively with Solvay," the Commission rejected this defense.²¹

3. Target Rebates

The Commission and the Community Courts have treated certain target rebates in a similar fashion to loyalty rebates. The leading case is *Michelin*, where the Court of Justice found Michelin's rebates linked to annual sales targets abusive.²² Michelin granted rebates to tire dealers based on an annual sales target that was established individually for each dealer on the basis of several criteria, including the dealer's estimated sales potential and Michelin's share of the dealer's total tire sales. The dealer did not know the criteria that Michelin used in calculating the target, which was not confirmed in writing but only orally by Michelin's representative. Moreover, it was very difficult for the dealer to ascertain how much it was earning on sales of Michelin tires, since dealers would often not discover what their final rebates were until they opened the envelopes that Michelin's representative gave them at the end of each year.²³

The Court found that this system had the effect of binding tire dealers to Michelin, restricting their effective choice of supplier. Crucial to this judgment was the fact that the reference period for the rebates was one year (i.e., if the customer achieved the sales target, it received a retroactive discount on its entire year's purchases from Michelin), which meant that even a small percentage reduction in the discount rate could signifi-

19. *Id.* at 33, para. 52.

20. *Id.*

21. *Id.* at 36, para. 61.

22. See *NV Nederlandsche Banden Industrie Michelin v. Comm'n*, Case 322/81, [1983] E.C.R. 3461 [hereinafter *Michelin*].

23. *Id.* at 3461, para. 28.

cantly affect the dealer's profit margin for the whole year. This pressured the dealer into buying from Michelin:

[A]ny system under which discounts are granted according to the quantities sold during a relatively long reference period has the inherent effect, at the end of that period, of increasing pressure on the buyer to reach the purchase figure needed to obtain the discount or to avoid suffering the expected loss for the entire period.²⁴

Another element that the Court cited was the fact that Michelin was much larger than its main competitors (around 65% market share, compared to 8% for the next-largest supplier). In the Court's view, Michelin's sheer size in the relevant market made it effectively an essential trading partner for tire dealers, who were forced to do business with Michelin. Moreover, the level of the targets on the basis of which Michelin granted the rebates represented a significant proportion of each dealer's total annual requirements for tires. Given this, Michelin's competitors could not, by offering discounts on their comparatively small sales volumes to the customer, equal the amount of the conditional rebate from Michelin that could be lost if the customer dealt with the competitor, to such an extent that it would lose the Michelin rebate. Thus, dealers were reluctant to deal with Michelin's competitors because Michelin's target rebates represented an important proportion of their total annual income, they were uncertain (dealers could not be sure of meeting them, even toward the end of the year),²⁵ and the risk of not achieving a Michelin target outweighed any possible benefit that a smaller supplier might have offered by selling a comparatively small amount of product even at lower prices than Michelin offered. The system thus significantly restricted dealers' ability to choose among suppliers, particularly near the end of each annual reference period.

Furthermore, the Court found that Michelin's target rebates were "calculated to prevent dealers from being able to select freely at any time in the light of the market situation the most favorable of the offers made by the various competitors."²⁶ This confirmed the Commission's view that the system was

24. *Id.* at 3517, para. 81.

25. *Id.* at 3517, para. 82.

26. *Id.* at 3518, para. 85.

“clearly aimed at tying the dealers closely to [Michelin] and thus making it difficult for other producers to gain a foothold in the market.”²⁷ In the face of this evidence of exclusionary intent, the Court rejected Michelin’s proffered justifications for the system. In 2001, a Michelin scheme with similar effects was condemned by the Commission in *Michelin II*.²⁸

Similarly, in *Irish Sugar*, the Court found the dominant supplier’s target rebate system on the retail sugar market abusive because it foreclosed competitors. Irish Sugar’s market share was above 85% and had been for almost a decade, and there was only one domestic competitor on the market.²⁹ Irish Sugar had set the reference period of the challenged target rebate (six months) specifically to coincide with competitors’ launch of new brands on the relevant market, evidencing its exclusionary intent.³⁰ The rebates were also offered only to certain customers of these new-entrants and target purchase levels were fixed at a figure near to the customer’s total requirements for the relevant product.³¹ The Court found that these measures effectively foreclosed competitors from the market; in fact, one such competitor went out of business only months after Irish Sugar started implementing its rebates.³²

Most recently, in *Virgin/British Airways*, the Commission likened the travel agent commission system employed by British Airways (“BA”) to the target rebate system condemned by the Court of Justice in *Michelin*, as both were created with the intention of, and had the effect of, preventing firms from selling their products in competition with the dominant supplier. BA’s travel agent commission system involved successively higher annual sales commission rates for travel agents selling BA tickets as they met various sales targets, with the targets defined as a percentage

27. Commission Decision No. 81/969/EEC, O.J. L 353/33, para. 38 (1981) [hereinafter *Michelin I* Decision].

28. See Commission Decision No. 2002/405/EEC, O.J. L 143/1 (2002) [hereinafter *Michelin II* Decision].

29. *Irish Sugar*, [1999] E.C.R. II-2984, para. 23.

30. *Id.* at II-3052-53, para. 203. See also *Irish Sugar* Decision, O.J. L 258/1, at 29, para. 152 (1997).

31. *Id.* at II-3052-53, para. 203. See also *Irish Sugar* Decision, O.J. L 258/1, at 29, para. 154 (1997).

32. *Irish Sugar*, [1999] E.C.R. II-3059, para. 222.

of that agent's sales of BA tickets in the previous year.³³ The Commission focused on BA's significant market share (42% of the market at the date of introduction of the rebates, compared to 5.8% for the next-largest supplier and less than 4% each for all others). As a result of its much larger sales base, BA could offer travel agents large monetary rebates by giving relatively small percentage discounts on their total annual purchases from BA. By contrast, BA's competitors would have had to offer very large percentage rebates on their lower sales volumes in order to equal the rebate payments from BA.³⁴ Because BA's target rebates represented an important proportion of their total annual income, the Commission said that travel agents were reluctant to deal with BA's competitors, since the risk of not achieving a BA target outweighed any possible incentive that a smaller airline might have created by making an attractive offer to sell additional flights. As in *Michelin*, therefore, travel agents were, according to the Commission, left with no realistic option as to the airline with which they dealt. The Commission also focused on BA's intent in implementing the system, concluding that BA had designed the rebates with the aim of foreclosing competitors: "[BA's rebates were] intended to eliminate or at least prevent the growth of competition to BA in the UK markets for air transport."³⁵ The decision is currently on appeal before the Court of First Instance.

B. *Defenses*

A number of possible defenses or justifications for different prices or other conditions, which might be contrary to Article 82 are available. The Court of Justice in *United Brands* held that a dominant company is entitled to charge differential prices based on a number of factors. The factors that the Court expressly mentioned were differences in costs (e.g., transport costs, taxation, customs duties, the wages of the labor force, the differences in the parity of currencies), and competitive conditions (market-

33. See Commission Decision No. 2000/74/EC, O.J. L 30/1, at 2, para. 3 (2000) [hereinafter *Virgin/British Airways Decision*].

34. *Id.* at 8, para. 30. The Commission calculated that a competitor would have to offer a discount of 17.4% on a travel agent's entire purchases from that airline in order to compete with a BA rebate of 0.5%. *Id.*

35. *Id.* at 23, para. 118.

ing conditions, and the density of competition).³⁶ The Commission has also accepted price reductions for “special customer status (e.g., [company] employees, affiliated companies, global and multinational accounts, educational and non-profit institutions, or government institutions”).³⁷ The list is not exhaustive but the principal defenses are set out below.

1. Volume-Based Discounts/Economies Of Scale

The Community Courts and Commission have invariably found standard volume rebates (e.g., offering a 10% discount to all customers whose purchases exceed a certain threshold level) unobjectionable. This probably reflects a number of considerations. First, such a system is non-discriminatory in the sense of Article 82(c), since it does not result in the application of dissimilar conditions to equivalent transactions. Second, in most cases, some cost savings probably result from serving larger customers.³⁸ Finally, the commercial reality in most industries is that large customers expect to receive better supply terms than smaller customers.

In *Hoffmann-La Roche*, the Court of Justice held that quantity discounts linked to customers’ purchasing volume would be permissible.³⁹ It found, however, that, on the facts, the price advantages granted were not based on the differences in volumes bought from Roche, but were expressly conditioned on the supply of all or a very large proportion of a customer’s total requirements by Roche.⁴⁰ Similarly, in *Irish Sugar*, the Court accepted that Irish Sugar’s border rebates in the retail sugar market would have been justified if they had been related to the purchasing volume of Irish Sugar’s customers.⁴¹ In that case, however, the

36. See *United Brands Co. and United Brands Continental B.V. v. Comm’n*, Case 27/76, [1978] E.C.R. 207.

37. Maurits Dolmans & Vincent Pickering, *The 1997 Digital Undertaking*, EUR. COMPETITION L. REV. 1998, 19(2), 108-15, at 113. See also *id.* at 114 (regarding customized or non-standard product offerings).

38. This consideration cannot, however, be the sole justification for the positive treatment of volume discounts. As Ridyard explains, “there is almost no plausible cost function that would make such a discount scheme ‘cost-related’ in the sense that the differences in price were explained by differences in the costs of supply.” Ridyard, *supra* n.4, at 289.

39. See *Hoffmann-La Roche*, [1979] E.C.R. 461.

40. *Id.* at 521, para. 22.

41. *Irish Sugar*, [1999] E.C.R. II-3042, para. 173.

rebates had been based solely on the customer's place of business (i.e., the rebate was granted only in cases where Irish Sugar considered that the price difference between Northern Ireland and Ireland might have induced cross-border sales), which was not an objective economic justification.⁴² Price reductions for larger quantities have been said by the Court of Justice in *Michelin* and *Portuguese Airports* to be lawful.⁴³

Likewise, discounts or rebates that reasonably reflect anticipated cost savings or economies of scale have generally been regarded as objectively justified and hence not abusive. For example, in October 1997, the Commission accepted an undertaking from Digital Equipment Corporation ("Digital") concerning the marketing and pricing of services for Digital computers that allowed Digital to offer owners of Digital systems reductions from list prices if they reflected "reasonable estimates of average cost savings or countervailing benefits."⁴⁴ In *Brussels National Airport (Zaventem)*, the Commission accepted that the airport authority's discount system on landing fees charged to airlines could be justified by economies of scale, i.e., the system would not be considered abusive if the authority could show that it cost less, in terms of administration and staff, to supply services to a carrier with a large volume of traffic at the airport.⁴⁵ More recently, the Commission recognized the same principle in its *Virgin/British Airways* decision: "a dominant supplier can give discounts that relate to efficiencies, for example discounts for large orders that allow the supplier to produce large batches of product."⁴⁶

It is not clear, however, whether the Commission considers that quantity rebates are legal only when they are based on identifiable cost savings. If it does think that, it is hard to see what its reasons would be. The pro-competitive importance (and the universal use) of quantity rebates is obvious and should not depend on whether the dominant firm can precisely identify corresponding cost savings. More fundamentally, dominant companies with high fixed costs should be free to charge different

42. *Id.*

43. See *Michelin*, [1983] E.C.R. 3461; *Portuguese Republic v. Comm'n*, Case C-163/99, [2001] E.C.R. I-2613 [hereinafter *Portuguese Airports*].

44. Dolmans & Pickering, *supra* n.37, at 113.

45. See Commission Decision No. 95/364/EC, O.J. L 216/8 (1995) ("*Brussels National Airport/Zaventem Decision*").

46. *Virgin/British Airways Decision*, O.J. L 30/1, at 20, para. 101 (2000).

prices to different customers if it benefits both parties to the lower-price transaction. Dominant companies may suffer cash flow shortfalls in times of recession, and in such circumstances may give price reductions, which might be *prima facie* contrary to Article 82. Conversely, a dominant company may decide that a large order is so important for stabilizing and planning its long-term production that it should give a price reduction to obtain it, even if it does not give rise to corresponding cost reductions. For these and other reasons, the UK competition authority, the Office of Fair Trading (“OFT”), recognizes that:

[p]rice discrimination between different customer groups can be a means of [recovering common costs]; it can increase output and lead to customers who might otherwise be priced out of the market being served. In particular, in industries with high fixed or common costs and low marginal costs . . . it may be more efficient to set higher prices to customers with a higher willingness to pay.⁴⁷

In other words, fixed-cost recovery should be a defense in cases involving price discrimination.

There is also no rule that price reductions based on cost savings are lawful only if comparable cost savings could be made in all other similar sales. Article 82 does not oblige the dominant company to make similar cost savings if possible in other cases, and to pass them on to other customers. It may be implicit in the cost reduction defense that the price reduction corresponds to the amount of the cost saving. But in many cases the price reduction is agreed before the precise extent of the cost reduction obtainable can be known, so the price reduction must be based on the seller’s estimate of what the cost reduction will prove to be: it cannot be criticized if that estimate turns out to have been wrong.

2. Price Reductions In Return For Services Rendered

Price reductions may also be given in return for services provided by the buyer, which are associated in some way with the sale. In *Michelin*, the Commission stated that discounts or rebates were justified if provided in exchange for valuable services performed by the customer:

47. Office of Fair Trading, *Assessment of Individual Agreements and Conduct, The Competition Act 1998*, 8 (Sept. 1999) [hereinafter OFT 414].

It is of course permissible, in the light of the competition rules laid down in the EEC Treaty, for an undertaking granting discounts, bonuses, etc. to take account of the services, which the retailer performs for the undertaking in selling its products. A particular example might be the customer service which the retailer may provide for final consumers and which the manufacturer himself would otherwise have to provide.⁴⁸

Similarly, in *The Coca-Cola Export Corporation – Filiale Italiana*, the Commission considered rebates “conditional upon the purchase of a series of sizes of the same product” and rebates “conditional on the carrying out by the distributor of a particular activity (re-arrangement and resupply of the shelves, use of advertising materials, etc.)” to be justified by legitimate business reasons.⁴⁹

In *Irish Sugar*, both the Court and the Commission confirmed that the rebates in that case would have been objectively justified if they had been based on, e.g., marketing and transport costs paid by the customer, or any promotional, warehousing, servicing or other functions that the customer might have performed.⁵⁰ However, they found that the dominant supplier’s offer of rebates based solely on the customer’s place of business as a means of targeting border customers was not objectively justified.

3. Responding To Competitors’ Prices

Price reductions that meet competitors’ prices have generally been regarded as legal under Article 82. However, in the case of certain rebate schemes calculated independently in advance by the dominant firm and largely without reference to competing offers (e.g., target rebates), the defense of meeting competition may be less relevant. In *United Brands*, the Court of Justice made clear that a dominant undertaking must be entitled to take such reasonable measures as it deems appropriate to pro-

48. Michelin I Decision, O.J. L 353/33, para. 45 (1981).

49. Commission Press Release IP/88/615 of October 13, 1988. See also Commission Decision No. 89/22/EEC, O.J. L 10/50 at 66 (1989) [hereinafter BPB Industries Decision]. Where similar reasoning was used, though, in that case, it was ultimately unsuccessful.

50. See *Irish Sugar*, [1999] E.C.R. II-3042, para. 173; *Irish Sugar Decision*, O.J. L 258/1, para. 129 (1997).

tect its own commercial interests, including responding to competitive offers on the market in order to maintain its customers:

[t]he fact that an undertaking is in a dominant position cannot disentitle it from protecting its own commercial interests if they are attacked, and . . . such an undertaking must be conceded the right to take such reasonable steps as it deems appropriate to protect its said interests.⁵¹

The Commission followed this reasoning, *inter alia*, in *AKZO*,⁵² *Hilti*,⁵³ *Tetra Pak II*,⁵⁴ *BPB Industries*,⁵⁵ *British Sugar/Napier Brown*,⁵⁶ and the 1997 Digital undertaking.⁵⁷

51. *United Brands*, [1978] E.C.R. 293, para. 189. The Court has repeated and affirmed this statement on multiple occasions since. See e.g., *BPB Industries plc and British Gypsum Ltd. v. Comm'n*, Case T-65/89, [1993] E.C.R. II-389, at II-418, para. 69; *Tetra Pak International SA v. Comm'n*, Case T-83/91, [1994] E.C.R. II-755, at II-826, para. 147; and *Compagnie Maritime Belge*, [2000] E.C.R. I-1472, para. 96.

52. See Commission Decision No. 83/462/EEC, O.J. L 252/20 (1983). Article 4 of the decision provided for interim measures against AKZO, but allowed AKZO to "offer or supply the said products at prices below [the minimum prices determined as above] . . . and only if it is necessary in good faith to do so to meet (but not to undercut) a lower price shown to be offered by another supplier ready and able to supply . . . to that undertaking." See also *AKZO v. Comm'n*, Case C-62/86, [1991] E.C.R. I-3359, at I-3475, para. 156. AKZO had threatened ECS that it would exclude it from the market unless it withdrew from competing in certain end-uses. AKZO then circumvented the interim measures ordered by the Commission and sold below average variable cost with predatory intent. Prices charged by AKZO were "well below" those of its competitors, showing that AKZO's intention "was not solely to win the order, which would have induced it to reduce its prices only to the extent necessary for this purpose." *Id.*, at I-3463, para. 102.

53. See Commission Decision No. 88/138/EEC, O.J. L 65/19 (1988) [hereinafter *Hilti Decision*]. Hilti was obliged to cease all price discrimination by ensuring that any differences in its prices were justified by differences in costs, except where it was necessary to depart from this in order to meet a competitive offer, in making promotions, or where to do so would generate sales that Hilti would not otherwise make.

54. See Commission Decision No. 92/163/EEC, O.J. L 72/1 (1992) [hereinafter *Tetra Pak II Decision*]. The argument that Tetra Pak was merely meeting competition was recognized but rejected on factual grounds.

55. See *BPB Industries Decision*, O.J. L 10/50, para. 134 (1989). The Commission accepted BPB's "Super Schedule A" prices because they were neither predatory nor part of any scheme of systematic alignment.

56. See *Napier Brown & Co. Ltd. v. British Sugar PLC*, [1990] 4 C.M.L.R. 196, para. 31. The Commission suggested that while undercutting a competitor's prices would be abusive, matching them would not.

57. The Commission recognized that even allegedly dominant companies must be allowed to offer price reductions (called "Allowances") in individual cases "to meet comparable service offerings of a competitor. No Allowance shall be offered until Digital has completed an internal review process designed to verify that the proposed Allowance is offered in good faith as a proportional response to real or (based upon information from the customer or other reliable sources) reasonably anticipated competitive

However, in *Irish Sugar* and *Compagnie Maritime Belge*, the Court, on the facts, disallowed “meeting competition” as a defense, even if it accepted that in principle it could be a defense.⁵⁸ Those cases suggest that discounting that “selectively and systematically” matches competitors’ bids may be abusive.⁵⁹ These cases should, however, be explained on the basis that the prices were combined with other exclusionary behavior, which, as explained in Part IV, distinguishes these cases from instances of a single abuse. *Irish Sugar* used a range of rebate and illicit commercial practices (e.g., product swaps) to insulate the Irish market from the incidence of imports from other Member States. In *Compagnie Maritime Belge*, there were also other abuses (exclusive contracts and 100% loyalty rebates). The CEWAL liner conference’s behavior was also admittedly intended to eliminate its only competitor and the conference members engaged in loss sharing among themselves for this purpose.

How far Article 82 is intended to protect competitors, and how far it should be interpreted to limit the extent to which dominant companies can compete, are fundamental issues. It is obvious that even dominant companies may compete, and should be encouraged to do so. If one customer can get a competitor to offer a low price, other similarly situated customers should be able to do so too, and matching that price is not likely to create a competitive disadvantage. It is also clear that any interpretation, which discourages a dominant company from lowering its price, even in one individual transaction, should be looked at very critically. Low prices for some sales are better than no low prices at all. It now seems (though it is not clear) from *Compagnie Maritime Belge* that a dominant company may undercut, as well as meet, a competitor’s price, provided that the effect of its practices is not to eliminate the only competitor, and provided that predatory prices are avoided.

offerings and will not result in a foreclosure or distortion of competition for the servicing of Digital systems in any Member State.” Dolmans & Pickering, *supra* n.37, at 113-14.

58. For example, in *Irish Sugar*, the Court of First Instance stated that “[t]here is no doubt that a firm in a dominant position is entitled to defend that position by competing with other firms on its market.” *Irish Sugar* Decision, O.J. L 258/1, at 22, para. 134 (1997).

59. See e.g., Philip Andrews, *Is Meeting Competition a Defense to Predatory Pricing? - The Irish Sugar Decision Suggests a New Approach*, EUR. COMPETITION L. REV. 1998, 19(1), 49-57.

A more difficult question is whether undercutting a competitor's price is a defense where Article 82(c) would otherwise be infringed (again assuming the price is not predatory). The question would arise if the two companies were bidding for a long-term contract for a substantial quantity, so that if the dominant company offered a specially low price to meet or undercut its rival's, it would create a disadvantage for its other customers, unless it reduced its price to them also (assuming that the transactions were similar). However, were a dominant company prevented from undercutting a competitor's price in that situation, not only would the dominant company be discouraged from competing, but its rival would have the benefit of a "price umbrella." The rival would know (if prices were transparent or the customer was reliable) that the dominant company could not undercut its price without extending the same reduction to all its other customers, at least in "similar" transactions. The rival would therefore know that it need not undercut the dominant company's standard price by very much or at all. The customer will also have an interest in claiming that a rival is offering a lower price, with the result that the lawfulness of a dominant company's price would depend to some extent on the customer's truthfulness. It is also likely that a dominant company will find itself competing against two rivals whose prices are unlikely to be identical. In these circumstances it may match the lower price, but this means that it undercuts the higher of the two rivals' prices. It would be nonsense to say that it was acting lawfully if the buyer was planning to take the lower price offer, but acting unlawfully if it planned to take the higher of the two offers. In other words, a rule that limited a dominant to meeting competitive offers could itself lead to anticompetitive and perverse results. It could also lead to companies' verifying each other's prices, which could give rise to serious issues under Article 81 of the EC Treaty.

There are also likely to be wider benefits to a rule that allowed a dominant firm to meet and undercut rivals' prices. If the dominant company was free to meet or undercut its rival's price in one transaction, it presumably would have to do the same thing again when its rival offered the same low price to other buyers, with the result that the general price level should come down. The better view therefore is that a dominant company may either meet or undercut a rival's price even when that

would be likely to create a competitive disadvantage for its other customers, since (if the rival remains in the market) the disadvantage is not likely to be a lasting one. This is also consistent with the Commission's increasing insistence that the purpose of Community competition law is to protect consumers and competition, not to protect competitors.

4. New Products And New Markets

Price reductions given by the dominant enterprise when it is launching a new product or entering a new market should also be lawful.⁶⁰ These practices are not designed solely to exclude competitors or to differentiate between customers, but constitute normal competition "on the merits." One apparent difficulty with this is that if a price reduction is lawful when entering a new market, should it not be lawful when selling to a new customer of the dominant enterprise? The answer seems to be that selling to a new customer in the same market, although pro-competitive, might create the kind of competitive disadvantage between customers that Article 82 was, wisely or unwisely, intended to prevent. Selling in a new market, whether a new geographical market or a new product market, will not create a disadvantage as between competing customers of the dominant company, as long as the markets are genuinely separate. Also, if a dominant company enters a new market, it is creating additional competition in that market, and this should be encouraged, particularly as economic integration is one of the objectives of the EU.

Although the issues do not seem to have arisen formally in any Commission case, it should be a defense to show that the lower price was given because the dominant company's goods were obsolete or perishable. It should also be a defense to show that the dominant company's price reduction was necessary to help the *buyer* respond to competition or enter a new market, or for some other pro-competitive reason. It should also be a defense to show that the product specification in the transaction, although similar to that in other sales, is unique, or that the transaction is one in which the buyer will be reselling under the

60. See *e.g.*, Dolmans & Pickering, *supra* n.37. The 1997 undertaking by Digital Equipment Corporation ("Digital"), allowed Digital to grant price reductions for "short-term promotional programs" provided that these are published, available on a non-discriminatory basis, and do not result in below-cost pricing. *Id.* at 113.

seller's label rather than its own, because this means that the transactions are not "similar" to other transactions. In many cases, several of these defenses will be available simultaneously.

C. *Other Comments*

1. Recent Commission Statements On Discounting

In the context of the above-mentioned cases, the Commission has made certain statements on rebate practices that would be extremely troubling if they were understood to represent the general state of the law on discounting. In *Virgin/British Airways*, the Commission summarized Community competition law on discounts as follows:

Community competition law limits the type of discount scheme that can be operated by a dominant firm. Discount schemes that are quite legitimate, and a normal part of business activity when practised by a non-dominant firm can be abusive when practised by a dominant firm. However it is clear from the Hoffmann-La Roche case that a dominant firm cannot enter into an agreement with a customer where the customer agrees to obtain all or most of their requirements for a product from that dominant supplier. The same case also indicates that *a dominant supplier cannot operate a discount scheme which has an equivalent effect to an agreement that a customer obtain all or part of its requirements from a dominant supplier.*⁶¹

But any generous discount may have an "effect" equivalent to such an agreement: the customer may find no better bargains, and buy only from that supplier. Any agreement by which anyone buys anything is an agreement to buy "part" of its requirements of that product or service. A little later, the Commission tries to use a clearer formula:

[A] dominant supplier . . . cannot give discounts or incentives to encourage loyalty, that is for avoiding purchases from a competitor of the dominant supplier . . . [A] dominant supplier can only give rebates in return for efficiencies realized and not in return for loyalty, that is for avoiding purchases from a competing supplier.⁶²

61. *Virgin/British Airways Decision*, O.J. L 30/1, at 20, para. 97 (2000) (emphasis added).

62. *Id.* at 20-21, para. 101.

This statement is also unhelpful, since it assumes that efficiencies and exclusivity are the only two possible reasons why a dominant firm would offer a discount. Rebates may be granted for all sorts of reasons, including customer buyer power and historical reasons. All discounts are meant to encourage the buyer to buy more and there is no reason why, absent some unlawful element, that circumstance is objectionable from an antitrust perspective. More fundamentally, the objection to loyalty discounts is not that they lead to a customer's not taking *some* products from a competitor, but that the conditions on which the dominant firm grants a discount are equivalent to anticompetitive *exclusive purchasing* requirements.

Similar statements were made in *Michelin II*. The Commission said:

In the first Michelin case . . . and consistently in more recent cases, the Court of Justice has ruled against the granting of quantity rebates by an undertaking in a dominant position where the rebates exceed a reasonable period of three months (as is the case here) on the grounds that such a practice is not in line with normal competition based on prices. Merely buying a small additional quantity of Michelin products made the dealer eligible for a rebate on the whole of the turnover achieved with Michelin and this was greater than the fair marginal or linear return on the additional purchase, which clearly creates a strong buying incentive effect.⁶³

While this is not very clear, and it certainly does not offer readers a useful indication of what may and may not be legally permissible, it is not plainly wrong. But the Commission went on: "In the Court's view, a rebate can only correspond to the economies of scale achieved by a firm as a result of the additional purchases which consumers are induced to make."⁶⁴ In other words, the Commission seems to think that identifiable cost-savings are the only legitimate justification for discounting practices.⁶⁵

Michelin II also contains other troubling statements. First,

63. Michelin II Decision, O.J. L 143/1 at 34, para. 216 (2002). Similarly, there are extremely troubling statements in British Gypsum, Commission Regulation No. 46/99 O.J. L 10/1 (1999) which suggest that any rebate aimed at increasing a dominant company's market share is or is likely to be unlawful. See also *BPB Industries*, [1993] E.C.R. II-389.

64. Michelin II Decision, O.J. L 143/1 at 34-35, para. 216 (2002).

65. See *Portuguese Airports*, [2001] E.C.R. I-2613, where the Commission stated that discounts offered by a dominant firm "must, however, be justified on objective grounds,

the Commission appears to have set itself an extremely low standard for assessing the materiality of foreclosure. The Commission stated that a *total* rebate of 150 FFR (approximately \$22) based on overall purchases of 15,000 FFR (approximately \$2,200) is “clearly quite substantial.”⁶⁶ Further, the Commission came very close to saying that any commercial practice by a dominant firm aimed at increasing market share may be unlawful under Article 82 when it stated that “an undertaking in a dominant position cannot require dealers to exceed, each year, their figures for the previous years and thus automatically increase its market share.”⁶⁷

Thus, read in isolation, and in the absence of a clear analytical framework, the Commission’s statements would lead a reasonable reader to believe that: (1) the use of certain target and loyalty rebates by a dominant firm is *per se* illegal; (2) discounts practised by a dominant firm must be justified by specific cost-savings or economies of scale;⁶⁸ (3) any discount that makes it rational for a customer to purchase all or even part of its requirements from a dominant firm may be unlawful; and (4) discounts that have the effect of increasing the dominant firm’s market share may be unlawful.

These statements have no economic basis and do not accurately paraphrase the case law of the Community Courts. *Hoffmann-La Roche* was concerned with express exclusivity contracts, or contracts that required the customer to purchase nearly all of its requirements from Hoffmann-La Roche in order to get the discount.⁶⁹ *Michelin I* was also concerned with rebates which were designed to lead to exclusivity and with the lack of transparency of the conditions that would attract the largest dis-

that is to say, they should enable the undertaking in question to make economies of scale.” *Id.* para. 49.

66. *Michelin II Decision*, O.J. L 143/1, at 36, para. 231 (2002).

67. *Id.* at 40, para. 263.

68. As Ridyard notes, this statement is particularly worrying:

A *per se* prohibition on price discrimination — i.e., a requirement that dominant firms should earn equal price-cost mark-ups on all their transactions — would be unduly restrictive and almost certainly lead to grossly inefficient outcomes in the context of fixed cost recovery industries. It would, for example, have the bizarre impact of outlawing the standard volume discount schemes operated by many dominant firms and which are generally deemed to be unexceptionable in competition law terms.

Ridyard, *supra* n.4, at 291.

69. See *Hoffman-La Roche*, [1979] E.C.R. 539-40, para. 89.

count.⁷⁰ In other words, the passages from these judgments relied upon by the Commission were only concerned with the question of how far cost reductions could justify the discounts in the cases before it, which were designed to lead to exclusive buying. Any wider interpretation takes the passages out of their context. It also disregards the only plausible antitrust objection to pricing that, after all, remains above cost: the discount is only granted in return for exclusive or near-exclusive purchasing. There is no wider principle that a dominant company cannot give a discount unless linked to clear cost savings or some other efficiency.

2. A Framework For Analyzing Community Competition Law On Discounting

Given the confusion that may have been created by certain Commission statements, it seems useful to restate that there should be no *per se* rules against pricing practices. If anything, lower prices that remain above cost should in nearly all cases be presumed legal and efficiency-enhancing. In regard to those pricing practices that have been reviewed by the Commission in the past, several situations should be distinguished:

- A discount conditional on the customer's buying all of its requirements from the dominant firm will usually be unlawful. However, in some cases, a discount in return for exclusivity may be legal where the dominant company is making a substantial investment in additional capacity that is economic only if the buyer commits to buying all its requirements from the dominant company for long enough to make the investment profitable.⁷¹
- A dominant company should be free to grant quantity rebates for all of its customers if that rebate is not predatory or conditional on that customer's not buying from third parties. This is simply a favorable list price, not individually negotiated. There is no need to show specific cost-savings or efficiencies related to that rebate. If quantity discounts are available, and in most industries they are,

70. See *Michelin*, [1983] E.C.R. 3461, para. 38.

71. In this respect the Court's findings in *BPB and British Gypsum* (Case T-65/89 [1993] ECR II 389, para. 68; and Case 310/93P, [1995] ECR I 865, para. 34) that it is not a defense that the buyer proposed an exclusive contract, while understandable, risks discouraging legitimate competition.

most buyers try to take advantage of them, and the best way to do that is to contract for a maximum achievable quantity. Discouraging quantity rebates would harm customers as well as competition. An unbeatable price may put a competitor out of the market or cause a customer to buy only from the supplier which offers it, but, in the absence of predation or an anti-competitive condition attached to getting the discount, that is legitimate competition.

- A dominant company can grant a discount on the *additional* purchases above a certain quantity or target threshold; this is simply a pro-competitive price reduction, and the buyer would be free to buy the additional quantity from any other supplier which offered a more favorable price for that quantity. This is true whether or not the quantity is individually negotiated. Again, there is no need to show identifiable cost-savings or efficiencies.
- A price reduction given on a buyer's purchases from a dominant supplier in a given period, which is granted *only* on the condition that the total quantity exceeds a target figure should usually be regarded as pro-competitive. This conclusion applies even if the quantity is individually negotiated, and even if the buyer has a strong incentive to buy most of its requirements from the dominant company to make sure that he gets the price reduction. However, a price reduction based on one or more individually-negotiated quantities may be illegal if it is structured in such a way that it creates a very strong incentive for the customer to buy all or nearly all of its total requirements from the dominant firm, whatever they may prove to be. Whether the loss of a cumulative rebate will in practice lead to exclusive or near-exclusive purchasing is highly fact-specific. In some cases, the scope for foreclosure may be more obvious,⁷² but it will generally be necessary to consider sev-

72. Consider a situation where a customer has annual requirements of ten units for a product and the dominant firm's list price is \$10 per unit. Assume further that the dominant firm has a stable market share of 70% in the relevant market and benefits from a strong brand or is an essential trading party in some respect, with the result that the customer has reasonably inelastic demand for seven units supplied by the dominant firm. However, the dominant firm proposes a rebate to the customer whereby any purchases in excess of seven units will attract a discount of 5% not only on the additional sales but also on all units purchased by the customer from the dominant firm

riod, so that the buyer was uncertain whether it had been reached or not (i.e., transparency).

III. DISCRIMINATION BETWEEN CUSTOMERS (ARTICLE 82(C))

A. *The Case Law*

There have been a number of cases dealing with secondary-line discrimination in Community competition law. Although, under the wording of Article 82(c), the emphasis is on preventing distortion of competition on a downstream market between customers, there is relatively little analysis in the case law of what constitutes a meaningful competitive disadvantage between customers.

In *United Brands*, the Court found that the dominant company had discriminated unlawfully between wholesaler banana ripeners.⁷⁴ It had sold the same bananas at the same Community ports at different prices to different wholesaler ripeners operating in different Member States, on the basis of the retail prices in each State. It was able to do this because it prohibited the wholesalers from selling unripened bananas, thereby effectively preventing arbitrage and re-exports. Once ripe, bananas are so fragile and perishable that no trade is possible, except immediate delivery to nearby retailers. In other words, the wholesaler ripeners would have been in competition with one another (and the price differences would have been large enough to create a competitive disadvantage) if United Brands had not also restricted competition by the clause prohibiting resale of unripened bananas. The Court confirmed that Article 82 does not prevent a dominant enterprise from setting different prices in different Member States, in particular where the price differences are justified by differences in the marketing conditions and in the intensity of competition. However, it may not apply "artificial" price differences, in the context of artificial partitioning of national markets. By "artificial" the Court apparently meant measures that are linked to practices that restrict competition, and are not based on pro-competitive reasons such as, for example, the need to maintain quality.

In *British Leyland*, the dominant enterprise had charged a

74. See *United Brands*, [1978] E.C.R. 207.

higher fee for certificates of conformity with national technical requirements for left-hand drive cars than for certificates for otherwise identical right-hand drive cars, to discourage imports of left-hand drive vehicles.⁷⁵ The Commission said this practice was discriminatory, and this was not seriously contested in the Court of Justice. Interestingly, the price difference primarily affected users, who were not normally in competition with one another, rather than the dealers selling the cars. The answer presumably was that the difference affected competition between dealers in different States, insofar as they were supplying to buyers resident in Belgium.

In *Deutsche Bahn*, the Court found that DB's conduct had contributed directly to maintaining a difference between the transport rate per kilometer to German and non-German ports.⁷⁶ There was a protective system of tariffs for carriage by rail passing through the northern (German) ports. This created a disadvantage for companies operating on the non-German rail journeys. Differences in the underlying costs were in part due to DB itself: cost savings had been achieved only for the northern ports, although there was no reason why they could not have been achieved on the western routes. As competition was more intense on the routes with the higher tariffs, competitive pressure could not explain the price differences. (This case can also be regarded as discrimination by a vertically-integrated dominant enterprise in favor of its own operations).

In *Aéroports de Paris*, the airports had charged different fees to companies providing certain ground services.⁷⁷ The Court said that this practice was comparable to that in *Corsica Ferries*, where the dominant enterprise had charged different prices to customers operating on domestic and international routes.⁷⁸ The concessionaire's turnover is an appropriate criterion by which to determine the variable part of the overall fee, but that criterion must be applied in a non-discriminatory manner to all groundhandlers. There was no justification for distinguishing

75. See *British Leyland Public Ltd Co. v. Comm'n*, Case 226/84, [1986] E.C.R. 3263.

76. See *Deutsche Bahn AG v. Comm'n*, Case T-229/94, [1997] E.C.R. II-01689.

77. See *Aéroports de Paris v. Comm'n*, Case T-128/98, [2000] E.C.R. II-3929.

78. See *Corsica Ferries Italia Srl v. Corpo dei Piloti del Porto di Genova*, Case C-18/93, [1994] E.C.R. I-1783.

eral elements in order to decide whether material foreclosure is probable. In reviewing each of these elements, market context (e.g., existence of countervailing power), established market practice (e.g., whether competitors offer similar schemes), and any efficiencies generated by the discount scheme are important to bear in mind.

1. The size of the discount. The larger the discount, the greater the incentive to purchase only from the dominant firm;
2. Whether the discount increases in a linear manner, or in steps, and if so what the quantity is for each step. A large increase in the level of the discount for additional purchases above the relevant target will create much greater marginal incentives;
3. The structure of market demand. If demand is more or less finite, cumulative discounts will tend to have a share-stealing effect and may therefore have a direct impact on opportunities for competitors. In contrast, if demand is growing significantly or there is considerable market opportunity for the product in question, a cumulative discount will tend to have a market-growing effect and will therefore be less liable to foreclose competitors;
4. The length of the reference period. Generally, the longer it is, the greater the cumulative effect of the discount will be in absolute terms. In *Michelin I*, the Court of Justice struck down a one year reference period. In *Coca-Cola/San Pellegrino*, the Commission accepted that rebates awarded on the basis of performance over a period of not more than three months would not be abusive.⁷³ In *Virgin/British Airways*, the

during the year. The result is that the dominant company's effective price for the eighth unit is \$6, which means that the rival will in most cases incur a loss in order to make that sale. These marginal incentives increase as the customer moves closer to the end of the reference period. In many cases, the dominant's company's effective price for the additional unit(s) will also be predatory, but that is not the objection. The objection is that the customer would have to buy exclusively or almost exclusively from the dominant firm in order to obtain any discount, which has the same effect as if it (unlawfully) agreed not to buy from a competitor.

73. See COMMISSION OF THE EUROPEAN COMMUNITIES, NINETEENTH REPORT ON COMPETITION POLICY 1989, at 65, para. 50 (1990). The same position was taken by the German Federal Cartel Office (Kammergericht – Kart 32779 *Fertigfutter*, Deutsche

Commission indicated in its press release that a six-month reference period might be acceptable. The upshot of these cases is that there is no general rule beyond the fact that a longer period will tend to lead to greater exclusion. Whether it does in practice is a question of fact that will also depend on other factors listed here;

5. Whether the buyer must buy some of its requirements from the dominant company, because there is no other supplier (in which case it is sure to acquire a cumulative rebate, which is sure to influence it), or whether it could buy all its needs from competitors if it chose. If a customer must buy a large number of units from the dominant firm, the effect of the cumulative rebate on sales above this fixed level is more likely to cause foreclosure. Stability of demand of the dominant firm's market share and a strong brand may also be relevant. A company with a stable and high market share and a strong brand is as a matter of probability more likely to cause foreclosure by cumulative rebates;
6. The proportion of the total market subject to the price reduction;
7. Whether the total quantity which the buyer would buy could be estimated in advance, or could be increased significantly if the buyer marketed actively enough (in the latter case, a target quantity is a legitimate incentive to effort);
8. Whether the quantity was known by both parties to correspond closely to the buyer's total requirements during the reference period;
9. Whether the quantity is higher than the buyer's purchases or sales of the seller's product in the previous period, without any corresponding increase in total demand, especially if this occurs in several periods in succession; and
10. Whether the quantity that would give rise to the price reduction was not disclosed during the reference pe-

between companies doing their own groundhandling and companies providing groundhandling for third parties.

The *Portuguese Airports* landing charges case concerned discounts that were granted on the basis of the number of landings made.⁷⁹ The Commission accepted that an enterprise in a dominant position is entitled to give quantity discounts. The Court added, quoting *Michelin*, that a dominant enterprise may offer quantity discounts linked solely to the volumes of purchases made from it. The Court therefore ignored, rather than clearly rejected, the Commission's argument that quantity discounts need to be objectively justified by economies of scale. As a result of the thresholds of the various discount bands, and the levels of discount offered, discounts were enjoyed only by a few particularly large companies, and the absence of linear progression in the increase of the discount was evidence of discrimination.⁸⁰ The biggest increases in the discount were given for the highest bands, which were obtainable only by the two Portuguese airlines. No objective justification or explanation was provided. Similarly, the Court referred to the *Corsica Ferries* case and said that different landing charges for domestic and international flights were discriminatory. The discrimination resulted from the application of a different tariff system for the same number of landings of aircraft of the same type.⁸¹

There are also a number of cases concerning rebate and discounting practices under Article 82 where the Commission and Community Courts alluded to the possible existence of discrimination between customers. However, in our view, these cases were primarily concerned with exclusionary behavior against competitors than discrimination between customers. The cases include *Irish Sugar* and *Virgin/British Airways*.⁸² (The

79. See *Portuguese Airports*, [2001] E.C.R. I-2613.

80. The Court was careful to point out, however, that "the mere fact that the result of quantity discounts is that some customers enjoy in respect of specific quantities a proportionally higher average reduction than others in relation to the difference in their respective volumes of purchase is inherent in this type of system, but it cannot be inferred from that alone that the system is discriminatory." *Id.* para. 51. In other words, it accepted that bigger customers get better bargains and that this circumstance does not of itself infringe Article 82(c).

81. See also Commission Decision No. 99/198/EEC, O.J. L 69/24 (1999) ("Finnish Airports Decision") (where similar issues arose).

82. See *Virgin/British Airways* Decision, O.J. L 30/1 (2000). This case is currently under appeal.

Commission's discrimination finding in *Michelin* was rejected by the Court of Justice.) For example, Irish Sugar offered low prices to customers depending on whether they were situated at border areas exposed to competition from imports or not. The Court of First Instance held that these discounts were discriminatory but did not explain how the customers competed with each other or how they would have been disadvantaged by the discount:

They [the border rebates] were given to certain customers in the retail sugar market by reference solely to their exposure to competition resulting from cheap imports from another Member State and, in this case, by reference to their being established along the border with Northern Ireland. [B]y the applicant's own admission, its economic capacity to offer rebates in the region along the border with Northern Ireland depended on the stability of its prices in other regions, which amounts to recognition that it financed those rebates by means of its sales in the rest of Irish territory. By conducting itself in that way, the applicant abused its dominant position in the retail sugar market in Ireland, by preventing the development of free competition on that market and distorting its structures, in relation to both purchasers and consumers. The latter were not able to benefit, outside the region along the border with Northern Ireland, from the price reductions caused by the imports of sugar from Northern Ireland.⁸³

Similarly, in *Virgin/British Airways*, the Commission stated that BA's rebate system discriminated between travel agents by granting agents selling a smaller number of tickets a proportionately higher rebate than those selling a large number of tickets. The Commission found that this rebate distorted competition between travel agents without explaining how that distortion was material:

The effect of these discriminatory commissions will be to place certain travel agents at a competitive disadvantage relative to each other. Travel agents must compete with each other to provide agency services to the public and to persuade members of the public to book air tickets through them. The resources available to the travel agents to do this by, for example, promoting their services to the public or by splitting commission with travelers, come from their commis-

83. *Irish Sugar*, [1999] E.C.R. II-3047-48, para. 188.

sion income. By distorting the level of commission income earned by travel agents these schemes will affect the ability of travel agents to compete with each other.⁸⁴

B. *Comments*

From the foregoing, it should be clear that Article 82(c) (or secondary line injury) plays a limited role in Community competition law. There are several reasons for this. First, the legal standard requires proof that the discriminated party has suffered a competitive disadvantage, that is price differences must have caused a material competitive handicap. At a minimum, this must mean that the discriminated customers have no readily-available alternative; customers compete with each other on a downstream market; the product in question is an important input cost for a downstream market either because it is resold at the retail level unchanged or it represents a significant percentage of the total cost of a derivative product; and the price difference is large enough to place the discriminated customers at an appreciable competitive disadvantage. There are not many situations in which all of those conditions would be met. If these conditions are not met, a dominant company does not otherwise have to explain differences in its prices.

Second, in any industry in which the products or services are adapted to the needs of customers, transactions are rarely sufficiently "similar" for Article 82(c) to apply. Many products are individually designed and produced by companies and there will often be reasons for objective differences between customers and between individual customer's orders.

Third, the circumstances in which Article 82(c) applies are inherently limited. If there is a possibility of arbitrage, a dominant company will not be able to charge its customers significantly different prices for the same or similar products. Even if there is no such possibility, the customers may protest and refuse to pay the higher price. In Europe, many companies sell at different prices to buyers in different Member States. Provided that the seller has done nothing to keep national markets separate, these price differences are usually lawful, for one or more of the reasons mentioned here.

84. *Id.* at II-3021, para. 111.

Finally, even if all of the conditions for showing competitive disadvantage are met, the defenses available under Article 82 outlined in the preceding section will in most instances justify the difference in price.

All of this makes sense. There is not — nor should there be — a rule of Community competition law that obliges a dominant company to offer all its customers a lower price if it offers a lower price to one of them. The EC Treaty does not require the same price to be offered to all customers. Particularly in an industry with high fixed costs and low marginal costs, differential pricing is a normal means of fixed-cost recovery, and should not be criticized. A strict non-discrimination rule would be anticompetitive and extremely inconvenient. A strict rule would mean that, if a dominant enterprise wanted to lower its price in a negotiation, it would have to consider whether it could lower its price in every comparable transaction. There would have to be a rule stating whether a dominant company that lowered its price had to give the reduction retroactively in contracts it had already entered into, or only in subsequent contracts. There would have to be a rule stating how long the enterprise would have to continue to charge the same price before it could raise its price again. It is obvious that companies do not do this, and that price competition would be very seriously discouraged if they were expected to.

In practice, this means that the principal situation in which the non-discrimination principle would be applicable and none of the valid defenses would likely be available concerns discrimination by a State-owned company between domestic and foreign companies for protectionist reasons. Several of the cases discussed above involve State-owned companies charging more favorable prices to companies of the same State, to companies selling products produced in the same State, or to companies flying on domestic as distinct from international routes. In each case, although there was no express discrimination on the grounds of nationality, it became clear that the purpose and effect was protectionist. However, it is not easy to visualize a situation in which a company that was not State-owned would have an interest in charging significantly different prices in genuinely similar transactions to customers that were in competition with one another. If this occurred, it would normally be because the buyers getting the lower price were starting up or were less able

or less willing to pay for some reason, and the seller believed that it could only make sales to them at a lower price. In other words, discrimination is relevant primarily in cases of concealed discrimination on the grounds of nationality.

IV. PREDATORY PRICING

A. *Introduction and Overview*

Predatory pricing involves pricing below some measure of cost for the purpose of eliminating competitors or deterring entry by potential rivals in the short run, thereby reducing competition through higher prices in the long run. In contrast to price cutting aimed at increasing or maintaining market share, predatory pricing has a different objective: causing the exit of rivals or ensuring that potential rivals would in the future be deterred from entering or from competing aggressively for fear of being pushed out of the market by strategic, below-cost price cuts. In either case, the explanation is that successful predation would allow the dominant firm to increase prices to above-competitive levels in the long run. We consider below the current approach to below-cost selling under Community competition law.

There has also been some discussion among economists whether predation can be successful where the dominant firm does not price below its costs but formulates a plan of strategic price-cutting to eliminate a rival. Indeed, as will be seen below, there is a much larger number of cases in Community competition law that have treated pricing above both average variable and average total cost as exclusionary than cases of pricing below average variable cost. Whether above-cost pricing can be exclusionary or should be treated as unlawful under antitrust law raises very difficult issues. On the one hand, there is a considerable body of economic and legal thinking that price-cutting on these lines is not an antitrust violation. If prices remain above cost, a company cannot otherwise complain that the price is too low, since it should be able to compete on the basis of such a price by achieving the same level of efficiency as the dominant firm. If a company cannot achieve equal or better efficiency, antitrust law should not offer it a safe haven or allow it to maintain unreasonably high prices. On the other hand, some economists argue that excluding rivals on the basis of above-cost pricing may lead to anti-competitive results if that exclusion is more or less

permanent and allows the dominant firm to raise prices post-exit. This applies particularly where entry barriers or re-entry costs are high or the dominant firm is active in several markets and acquires a reputation for taking drastic action against new entrants in one of its markets. We also consider this category of potentially exclusionary pricing.⁸⁵

Any set of rules that deal with predatory pricing must address two fundamental questions: (1) What *economic model* do you apply to determine whether price-cutting can give rise to predation? (2) What *legal rules* should govern the application of the underlying economic model to determine whether the price-cutting in question is unlawful? In deciding which economic model and legal rules should apply, there is an even more important (and sometimes difficult to reconcile) underlying objective. The underlying objective is, on the one hand, to ensure that the chosen approach does not allow predatory behavior to go undetected, and, on the other hand, to allow firms to compete on price to the widest possible extent. In addition, enforcement of whatever approach chosen must not be complicated, since a complex rule that is costly to enforce can create enforcement and welfare costs of its own. It should also be borne in mind that perfect information will almost never be available in the context of litigation or administrative action. In other words, the optimal rule may never be properly applied, which will also have welfare implications.

There are several possible approaches to predatory pricing under antitrust law. However, even if there is agreement that predatory pricing may be profitable and anti-competitive, no one rule could possibly capture all the situations in which that would occur, still less gain universal acceptance:

- **NO RULE.** A small number of economists and lawyers consider that no distinct rules are required to deal with predatory pricing.⁸⁶ The argument runs as follows. To suc-

85. Predatory conduct may also occur on the basis of non-price factors, such as vexatious litigation or some other form of behavior designed to raise rivals' costs or cause them artificial competitive handicaps. These actions are no less serious than predatory pricing and may, in fact, be more serious given that they may be less costly to pursue; not easily detected; and are not yet governed by clear legal rules. These are not, however, discussed further in this Article.

86. The leading advocate of such an approach is Robert H. Bork. See ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 145 (1978).

cessfully engage in predation, a firm must forego the (higher) profits that free competition would bring in order to later recoup monopoly profits that would exceed the losses incurred. It must also be probable that there are sufficient barriers to re-entry or new entry to ensure that the monopoly profits can be maintained: prices at above-competitive levels will usually attract entry. Absent these elements, predatory pricing would be irrational. In other words, predatory pricing is by nature speculative and in practice unlikely. Even if there is agreement that predatory pricing cases are relatively rare, this theory has not gained widespread acceptance.

- **COST-BASED RULES.** The concept implicit in predatory pricing is that the price charged is below some measure of cost. This has led a number of economists to argue that rules based on the identification of prices that are above/below cost are appropriate to prevent predatory pricing. The classic model used in this connection is the Areeda & Turner test developed in the 1970s.⁸⁷ Under this model, prices that are below the average variable cost (i.e., costs that vary with the amount of output produced) of the product in question are presumed to be predatory. The idea is that a rational, profit-maximizing firm would have no interest other than predation in pricing at such a level. Areeda & Turner's classic model has been commented on and criticized in several other articles.⁸⁸ It has, however, gained reasonably widespread judicial endorsement, both in the U.S. and the EU. This may partly be due to its relative simplicity, or at least the fact that it is more easily ap-

87. See Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975) (later restated and modified in PHILLIP AREEDA & DONALD F. TURNER, *ANTITRUST LAW: AN ANALYSIS OF ANTI-TRUST PRINCIPLES AND THEIR APPLICATION* 148-93 (1978)).

88. See, e.g., F.M. Scherer, *Predatory Pricing and the Sherman Act: a Comment*, 89 HARV. L. REV. 869 (1976); Phillip Areeda & Donald F. Turner, *Scherer on Predatory Pricing: a Reply*, 89 HARV. L. REV. 891 (1976); F.M. Scherer, *Some Last Words on Predatory Pricing*, 89 HARV. L. REV. 901 (1976); Richard A. Posner, *Antitrust Law: An Economic Perspective* (1976). For a detailed treatment of the link between the economic literature and legal doctrine in the United States, see Joseph F. Brodey & George A. Hay, *Predatory Pricing: Competing Economic Theories and the Evolution of Legal Standards*, 66 CORNELL L. REV. 738 (1981).

plied and understood by lawyers than some of the suggested alternatives.

- **NON-COST BASED RULES.** Given the difficulties in identifying and allocating costs, and in formulating legal rules based on measures of cost, certain economists and lawyers argue that cost-based rules are inappropriate.⁸⁹ Several alternative approaches have been suggested. One approach, advocated by Oliver Williamson, is to assess the dominant firm's strategic positioning of output to effectively deter new entry without pricing below cost.⁹⁰ Williamson argued that a dominant firm can choose a plant size and capital structure in anticipation of new entry that permits it to respond to entry in such a way as to ensure that the entrant loses money. A more extreme approach, advocated by William Baumol, is to require the dominant firm to continue any price reduction for a fixed period if the rival exits.⁹¹

B. *Below-Cost Selling in Community Law*

Article 82 does not expressly prohibit predatory pricing. Predatory pricing may, however, involve elements of discrimina-

89. Clearly, cost-based rules may not be appropriate in all situations. There are industries with very high fixed costs where the cost of serving an additional customer or laying on an additional service may be minimal. In these cases, costs may be an unreliable guide to the lawfulness of a dominant firm's competitive strategy. The most obvious cases arise in the maritime and air transport sectors. In the United States, a Department of Transportation study has concluded that exclusionary practices have occurred in the industry without below-cost selling, in particular where the incumbent targets a new entrant on its hub with capacity expansion and selective pricing. See *Enforcement Policy Regarding Unfair Exclusionary Conduct in the Air Transportation Industry*, Department of Transport Act, Pub. L. No. 1998-3713, 1847 (2001). However, this study has not led to any final guidelines for assessing exclusionary behavior and none are, we understand, expected in the near future. In the EU, the Commission also seems sensitive to specific concerns in the air transport sector. In clearing a recent partnership between Austrian Airlines and Lufthansa, the Commission required, *inter alia*, that each time the airlines reduce a published fare on a route where they face the presence of a new entrant, they should apply the same fare reduction, in percentage terms, on three other routes on which they do not face competition. See *Commission announces intention to clear partnership between Austrian Airlines and Lufthansa*, Press Release IP/01/1832 (Dec. 14, 2001). It is not clear whether such a remedy could be imposed in a final decision but it does have some pragmatic appeal.

90. See Oliver E. Williamson, *Predatory Pricing: a Strategic and Welfare Analysis*, 87 *YALE L.J.* 284 (1977).

91. See William J. Baumol, *Quasi-Permanence of Price Reductions: a Policy for Preventing Predatory Pricing*, 89 *YALE L.J.* 1 (1979).

tion (Article 82(c)) or attempts to limit competitors' output (Article 82(a)). Relying on a combination of these principles and the fact that the list of abuses under Article 82 is not exhaustive, the Commission and the Community Courts have treated predatory pricing as unlawful. In terms of economic models, Community competition law relies on a mixture of cost-based models and evidence of a plan to eliminate a rival.

There are only three cases in which below-cost selling has been successfully challenged under Community law. (*Deutsche Post*, which involved predation through cross-subsidization, is discussed in Part V.) The first case is *AKZO/ECS*, where the Commission adopted both an interim measures decision and a final decision against AKZO for various pricing practices in the organic peroxides sector.⁹² The Commission's final decision was upheld by the Court of Justice. The relevant facts were as follows. AKZO was active in the production of a wide range of organic peroxides and had a stable market share of approximately 50-55%. A small segment of this overall market concerned the use of organic peroxide as a flour additive to bleach flour. Flour additives were only used at the relevant time in Ireland and the United Kingdom. ECS was active in this sector, which accounted for the majority of its turnover, and held a market share of approximately 35%. The Commission found that AKZO had made threats to ECS in a meeting aimed at securing ECS's withdrawal from another segment of the organic peroxides market in which it was active. AKZO threatened that, unless ECS withdrew from this segment, it would face retaliatory measures in the flour additives segment. The Commission also found that AKZO engaged in a series of below-cost pricing practices in the flour additives sector, including below-cost pricing for certain additives generally and selectively below-cost prices to ECS's customers only. (AKZO's prices were certainly below average total cost and there were suggestions that they were below average variable cost too.) The Court of Justice agreed with the vast majority of these findings.

The principal interest of the judgment lies in the Court's findings on the appropriate test to be applied under Community law for predatory pricing. The Court adopted a two-part test

92. See Commission Decision No. 85/609/EEC, O.J. L 374/1 (1985) [hereinafter *ECS/AKZO Decision*].

based on costs and intent. The Court held that prices below average variable cost are presumed to be predatory, while prices above average variable cost but below average total cost are predatory where they are part of a plan by the dominant firm to eliminate a competitor. This test broadly endorses the approach advocated by Areeda & Turner. The Court's findings also partly rejected the thesis put forward by the Commission. The Commission argued that the decisive criterion under Article 82 should not be costs, but the strategic objective behind the price-cutting. The Commission accepted, however, that costs might be of considerable importance in establishing the reasonableness of the dominant firm's conduct.

The second case was *Tetra Pak II*.⁹³ Tetra Pak was found to have committed a range of abuses in the aseptic and non-aseptic machinery and carton sectors. These included both abusive contractual terms and conditions and unilateral pricing practices. Tetra Pak's market share in the various aseptic machinery and carton markets was approximately 90% and had remained stable over time. Although Tetra Pak's share in the various non-aseptic markets was lower (approximately 50%), the Court of Justice found that there were important associative links between the aseptic and non-aseptic markets. In regard to predatory pricing, the Commission's case was that Tetra Pak had engaged in predatory pricing in relation to its Tetra Rex non-aseptic carton by pricing below average variable cost. Tetra Pak argued that its prices were not intended to eliminate competitors because they were in response to intense competition from a competing non-aseptic product offered by Elopak. After analyzing Tetra Pak's costs, the Court concluded that Tetra Pak's costs were not only below average total cost but also below average variable cost. Under the rules established earlier by the Court in *AKZO*, these prices were presumptively predatory and unlawful.

From a legal perspective, the most interesting aspects of the judgment concern the Court's statements on recoupment. Certain U.S. courts have held that recoupment is an element of the test for predatory pricing.⁹⁴ It concerns the need to demon-

93. See *Tetra Pak II Decision*, O.J. L 72/1 (1992), *appeal filed*, *Tetra Pak International SA v. Comm'n*, Case T-83/91, [1994] E.C.R. II-755.

94. See *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993). The other element of the test for predatory pricing under U.S. law is to show

strate the likelihood that the dominant firm would recoup the losses sustained through the price cuts by being able to profitably raise prices after having successfully caused rivals' market exit. The Court of Justice held that, on the facts of the case, "it [was] not necessary to demonstrate that the undertaking in question had a reasonable prospect of recouping losses so incurred."⁹⁵

C. Above-Cost Exclusionary Pricing in Community Law

A number of cases under Community competition law have treated pricing above average variable cost (and even average total cost) as exclusionary. Many of these cases rely on circumstantial evidence of intent to eliminate a rival by the dominant firm. They are, however, unsatisfactory from an analytical point of view in several respects. First, the Community Courts and the Commission have not always clearly articulated the antitrust objection: in some cases, the objection seemed to be based on discrimination between end-users; in others it has been assumed, but not satisfactorily explained, that competitors would be excluded by a low (but above-cost) price. Second, many of the cases involved evidence of other exclusionary behavior. As explained below, we distinguish these cases analytically from instances of a single abuse. Finally, and perhaps most fundamentally, neither the Commission nor the Community Courts have explained in any satisfactory way how the rules for these cases differ from the rules concerning predatory pricing. As explained above, the second *AKZO* rule provides that pricing above average variable cost but below average total cost is unlawful if there is proof of a plan to eliminate a competitor. This means that there must be some additional element for above-cost pricing to be treated as illegal under Community competition law. We argue below that pricing above average variable cost can only be unlawful if that pricing is coupled with other clearly exclusionary conduct.

Hilti concerned a series of cumulative measures by a manufacturer of nail guns designed to deter customers who purchased its nail guns from purchasing nails from competing nail manu-

that the prices complained of are below "an appropriate measure of its rival's cost." *Id.* at 210.

95. *Tetra Pak*, [1994] E.C.R. II-827, para. 150.

facturers.⁹⁶ These measures included tied sales, inducing independent distributors not to fulfill export orders, refusing to honor guarantees for customers who purchased competing nails, and various selective and discriminatory pricing policies. On the pricing issues, Hilti was found to have offered customers who purchased both its nails and guns more favorable discounts than those that only purchased Hilti's guns and a competitor's nails. This discount was not based on any efficiencies but the fact that the customer would be dissuaded from purchasing competing nails. The Commission concluded that the pricing practices were illegal because they were "designed *purely* to damage the business of, or deter market entry by, its competitors, whilst maintaining higher prices for the bulk of its other customers, is both exploitative of these customers and destructive of competition".⁹⁷ The Community Courts were not clear on the antitrust objection to these pricing practices. They held that the strategy employed by Hilti was not a legitimate mode of competition, since it was liable to deter other undertakings from establishing themselves in the market and that the Commission "had good reason to hold that such behavior on Hilti's part was improper."⁹⁸ The Community Courts did not explain how Hilti's prices – which were not found to be below cost – would exclude rivals or deter their entry.

In *BPB Industries*, the Commission condemned discounts offered by BPB to plasterboard retailers that stocked only its plasterboard product.⁹⁹ However, the Commission allowed BPB to maintain discounts for retailers in certain areas of England that were exposed to foreign competition, since there was no suggestion that these discounts "were in themselves predatory, nor part of any systematic alignment."¹⁰⁰

Irish Sugar also concerned a series of cumulative measures by the dominant sugar producer in Ireland designed to keep out competitive imports of sugar produced in other Member States.¹⁰¹ Among the measures employed by Irish Sugar were selective pricing, export rebates, price discrimination, granting re-

96. See *Hilti AG v. Comm'n*, Case T-30/89, [1991] E.C.R. II-1439.

97. *Hilti Decision*, O.J. L 65/19, at 35, para. 81 (1988) (emphasis added).

98. *Hilti*, [1991] E.C.R. II-1483, para. 100.

99. See *BPB Industries Decision*, O.J. L 10/50, para. 129 (1989).

100. *Id.* para. 133.

101. See *Irish Sugar Decision*, O.J. L 258/1 (1997); *affirmed in Case T-228/97*,

bates to customers located in border areas, product swaps and fidelity rebates, and target rebates. The border rebates in question were a scheme entered into by Irish Sugar and its distribution arm, SDL, under which rebates were offered only to retail customers located close to the border of Northern Ireland, where Irish Sugar had lost sales to competing sugar imports from the United Kingdom. Irish Sugar claimed that those rebates were a legitimate response to meeting competition, and could not be offered to all customers because of Irish Sugar's loss-making position. In finding the border rebates abusive, the Court of First Instance did not focus on whether the prices offered were exclusionary of competitors but instead seemed to focus on their market-partitioning effect and possible discrimination between customers:

In this case, the applicant has been unable to establish an objective economic justification for the rebates. They were given to certain customers in the retail sugar market by reference solely to their exposure to competition resulting from cheap imports from another Member State and, in this case, by reference to their being established along the border with Northern Ireland. It also appears, according to the applicant's own statements, that it was able to practise such price rebates owing to the particular position it held on the Irish market. Thus it states that it was unable to practice such rebates over the whole of Irish territory owing to the financial losses it was making at the time. It follows that, by the applicant's own admission, its economic capacity to offer rebates in the region along the border with Northern Ireland depended on the stability of its prices in other regions, which amounts to recognition that it financed those rebates by means of its sales in the rest of Irish territory. By conducting itself in that way, the applicant abused its dominant position in the retail sugar market in Ireland, by preventing the development of free competition on that market and distorting its structures, in relation to both purchasers and consumers. The latter were not able to benefit, outside the region along the border with Northern Ireland, from the price reductions caused by the imports of sugar from Northern Ireland.¹⁰²

Compagnie Maritime Belge concerned various practices car-

[1999] E.C.R. II-2969; and *Irish Sugar v. Comm'n* Case C-497/99 P, [2001] E.C.R. I-5333.

102. *Irish Sugar*, [1999] E.C.R. II-3047-48, para. 188.

ried out by the CEWAL liner shipping conference operating between Zaire and certain European ports, including adherence to an agreement with the government of Zaire that led to de facto exclusivity on certain routes for CEWAL, the imposition of 100% loyalty contracts, and the practice of "fighting ships."¹⁰³ "Fighting ships" is an established (but frowned upon) practice in maritime transport whereby sailing times are fixed as closely as possible to those of a competing liner and special discounted freight rates applied for those sailings only. CEWAL, which enjoyed a de facto monopoly on the relevant routes, carried out certain "fighting ship" practices for the avowed purpose of "getting rid" of its competitor G&C.

Both Community Courts held that this practice was abusive. In reaching this finding, they expressly rejected the appellants' argument that selectively low prices could not be abusive unless they were below cost within the meaning of *AKZO*. The Courts held that there were features of CEWAL's conduct that rendered the selectively low prices abusive: (1) the practice was carried out for the express purpose of eliminating G&C, CEWAL's only competitor; (2) CEWAL apportioned the losses incurred by the price-cutting among them; and (3) price competition was already weakened in the maritime transport sector because the applicable legislation allowed collective tariff setting. However, the Community Courts were very careful to limit their findings to the unusual circumstances of the case. The judgment did not address in what circumstances a dominant company may be allowed to respond to competitive offers with selectively low prices:

It is not necessary, in the present case, to rule generally on the circumstances in which a liner conference may legitimately, on a case by case basis, adopt lower prices than those of its advertised tariff in order to compete with a competitor who quotes lower prices . . . It is sufficient to recall that the conduct at issue here is that of a conference having a share of over 90% of the market in question and only one competitor. The appellants have, moreover . . . admitted at the hearing, that the purpose of the conduct complained of was to eliminate G&C from the market.¹⁰⁴

103. Commission Decision No. 93/82/EEC, O.J. L 034/20 (1993), *upheld on appeal* in *Compagnie Maritime Belge*.

104. Court of Justice of the European Communities (Fifth Chamber), *Compagnie Maritime Belge*, [2000] All E.R. (EC) 385, paras. 118 and 119 (2000).

D. *Comments*

1. Can Above-Cost Pricing Lead To Unlawful Exclusion?

As indicated above, Community competition law envisages situations in which prices above average variable cost (and even prices above average total cost) may be abusive. The result of these cases appears to be that it is abusive for a dominant company to set out to eliminate a competitor entirely from the market, whether by forcing it out or by preventing it from getting a foothold. This may be legitimate if it is done by generalized low prices. However, if the action is selective and goes further, by significant undercutting or otherwise, than is necessary merely to respond to competitive prices, and if selective price cuts are combined with other exclusionary and not merely a response to competition, then it seems that the price cuts as well as the other conduct are unlawful. Community competition law suggests that a dominant company may react to competition, but must not overreact. Intent to eliminate a specific rival will also be considered an aggravating factor in this connection.

There are significant problems with this interpretation were it to come to represent the general state of the law on above-cost price-cutting without further qualification. In particular, although the Commission and the Community Courts have made it clear that, in principle, selectively low prices designed to respond to competitive offers are legal, they have in practice proceeded to condemn nearly every instance where it has been raised as a defense. Some of these cases concerned particularly egregious conduct, but it is important that prices above average variable cost should benefit from a very strong presumption of legality. The situations in which a competitor can claim that a price that remains average variable cost is anti-competitive should be very narrowly circumscribed. Before attempting to rationalize these cases under Community competition law, it seems useful to explore the principal economic and legal arguments on whether pricing above average variable cost can be anti-competitive.

a. The Theoretical Underpinnings Of Above-Cost Exclusionary Pricing

A number of leading antitrust scholars, including advocates of the need for legal rules to prevent predatory pricing, argue

that all pricing above average variable cost should be presumed lawful. In essence, this conclusion assumes that firms that are equally or more efficient than the dominant firm can compete on the merits on the basis of pricing above average variable cost and that there is no reason why antitrust law should offer them a safe haven against price competition in that circumstance. There is no net welfare loss if less efficient companies are eliminated. As Richard Posner has noted: “[a] seller may want to destroy a competitor, but if the only method used is underselling him by virtue of having lower costs there is no rational antitrust objection to the seller’s conduct.”¹⁰⁵ Areeda & Turner make a similar point: “The low price at or above average cost is competition on the merits and excludes only less efficient rivals.”¹⁰⁶

On the other hand, some economists argue that even prices above average variable cost can be predatory and anticompetitive. B.S. Yamey and Aaron Edlin have argued that there are a number of instances in which predatory pricing can occur where the dominant firm prices above its own costs but below those of a rival. In such situations, they argue that the dominant firm can eliminate a rival without incurring losses itself and will be free to raise prices thereafter to above competitive levels.¹⁰⁷ Edlin points to a number of situations in the U.S. air transport sector where, in response to new entry, the incumbent monopolist added capacity and reduced prices to levels that remained above-cost only to increase prices back to pre-entry (monopoly) levels when the entrant had been eliminated. He summarizes the qualitative reasons why a dominant firm’s costs may not be a reliable guide to the exclusionary nature of its pricing as follows:

[A]bove cost predatory pricing is possible if rivals have higher costs than the incumbent monopoly (where predatory pricing means low prices that hurt consumers by limiting competition). After all, a firm rarely achieves a monopoly without one or more advantages. Any such firm probably has gone down the cost learning curve and produces more efficiently than a newcomer. The industry may enjoy increasing returns to scale or scope. The firm may simply have a first-mover ad-

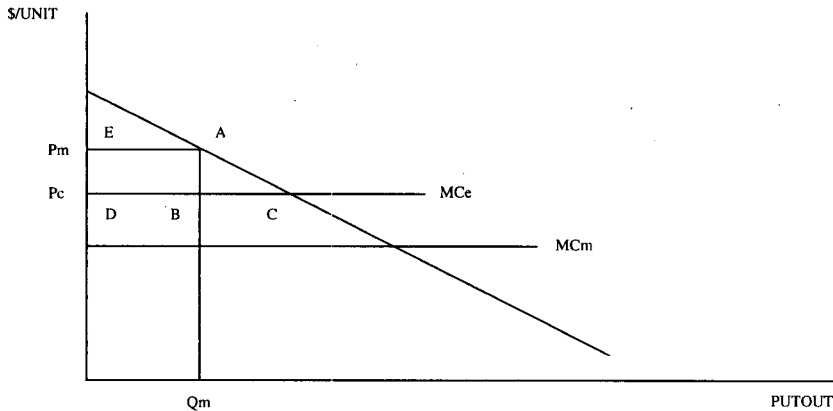
105. Posner, *supra* n.88, at 188.

106. Areeda & Turner, *supra* n.87, at 706.

107. See B.S. Yamey, *Predatory Price Cutting: Notes and Comments*, 15 J.L. & ECON. 129 (1972); see also Aaron S. Edlin, *Stopping Above Cost Predatory Pricing*, 111 YALE L.J. 941 (2002).

vantage and be able to hide behind entry barriers from start-up costs. It may have figured out how to make a superior quality product, enjoy demand-side network externalities, or simply have a familiar and trustworthy brand like Nutrasweet. Some advantage or combination of advantages gives the firm monopoly power in the first place. The very advantages that give a firm monopoly power can allow it to drive out rivals without pricing below cost.¹⁰⁸

In quantitative terms, it is also possible to explain how above-cost pricing might lead to undesirable exclusion. George Hay posits the following simple example.¹⁰⁹ A new entrant has costs (MC_e) that are below the price (P_m) charged by the dominant company but greater than the dominant firm's costs (MC_m). Upon entry, the dominant firm lowers its price to P_c , the entrant's break even point. Under the Areeda & Turner model, the dominant company can still lower its price further below P_c as long as it does not go below its own costs. The entrant is therefore making a loss and exits the market only for the price to return to the pre-entry monopoly level, P_m :



Source: Hay, *A Confused Lawyer's Guide To The Predatory Pricing Literature*

Exit in these circumstances might seem undesirable but the key question is whether there is a net deadweight loss. Conceivably, yes. Assuming the new entrant captures a certain market share

108. Edlin, *supra* n.107, at 963.

109. See George A. Hay, *A Confused Lawyer's Guide to the Predatory Pricing Literature in JOURNAL OF REPRINTS FOR ANTITRUST LAW AND ECONOMICS*, Vol. XVIII, No. 2, 155-203 (1988).

on the basis of price P_c , consumers will benefit from lower prices than in the pre-entry situation where the price was P_m . This should offset any deadweight loss caused by the lesser efficiency achieved by the new entrant. It should also be remembered that the new entrant should, over time, move down the learning curve in the market and achieve greater efficiency.

b. How to Understand The Case Law Under Community Competition Law

Economic literature to the effect that, exceptionally, prices above the dominant firm's costs can be anticompetitive may help explain why such pricing practices have been condemned in several cases under Community competition law. However, this literature does not address whether a legal rule to that effect is necessary or identify the legal criteria for such a rule under Community competition law. In our view, there are three *possible* interpretations of the case law, but only one — the first — is correct.

i. Cumulative evidence of abusive behavior

The first explanation for the case law is that pricing above average variable cost is only unlawful where it is coupled with a range of other exclusionary measures, i.e., there is cumulative evidence of abuse as part of a plan to eliminate a rival. The pricing is not unlawful in itself but can be viewed as unlawful where linked with other exclusionary practices. The pricing is a key part of an overall exclusionary policy and there is no other explanation for it. It could not be regarded as pro-competitive conduct which happened to coincide in time with an exclusionary policy: it made sense only as part of that policy and was clearly linked to that policy. While imprecise, this interpretation is one that the legal advisers of a dominant company can use.

Irish Sugar, *Hilti*, and *Tetra Pak* could all be explained on that basis. In those cases there were not only selectively low prices but also fidelity rebates, tying, exclusive contracts, and target rebates. The above approach was also effectively taken by the Advocate General and the judgment of the Court of First Instance in *Compagnie Maritime Belge*. The Advocate General said that the various practices were designed to drive the competitor from the market at minimal cost to the dominant companies, so

as to restore their virtual monopoly and raise their prices thereafter. The assumption is that any set of practices which are designed to exclude a competitor from the market and which are likely to succeed in their aim are likely to constitute a barrier to entry, and that they cannot be regarded merely as legitimate price competition.¹¹⁰

In that regard, intent or selective price-cutting targeted *only* at that rival may offer evidence of an exclusionary plan, provided, of course, there are exclusionary measures in addition to the low prices. However, it must always be remembered that dominant firms are entitled to compete and to match and beat competitors' prices if they remain above average variable cost. There are also different types of intent. Sales hyperbole is different from an egregious plan with the avowed purpose of putting a rival out of business by any means. Most fundamentally, however, while intent or selectivity may offer some indication of the strategic objectives behind the price-cutting, they do not excuse a plaintiff or regulator from demonstrating that the price-cutting would in fact lead to unlawful exclusion.

ii. "Superdominance"

The second explanation — which we do not accept — concerns situations where there are very high barriers to entry, or "superdominance" as it has become fashionably known. In such cases, it is argued that the effect of the dominant company's excluding a new entrant through strategic price-cutting may be a quasi-permanent monopoly. There has been some recent discussion of this situation in the EU and cases such as *Tetra Pak* and *Irish Sugar* could also be explained on the basis of such a theory. In *Compagnie Maritime Belge*, it was suggested that the scope of the duties of a company in a dominant position must be considered in the light of the specific circumstances of each

110. A possible sub-set of the first category concerns pricing that is intended to insulate Member States from products imported from other Member States. For example, in *Irish Sugar*, considerable importance was attached to the fact that the sugar markets in Ireland were already insulated from competition through protectionist government policies and that Irish Sugar used all available means to keep imports of foreign sugar out of Ireland. The Court of First Instance clearly stated that this was inimical to the purpose of the single market and the objectives of the EC Treaty. See *Irish Sugar*, [1999] E.C.R. II-3046, para. 185. However, it is submitted that this approach is of limited economic relevance: whether a price is exclusionary should not depend on the location of the competing supplier.

case, and that a company with a particularly high market share may have stricter duties under Article 82 than those of a “normal” dominant enterprise.¹¹¹ Advocate General Fennelly put the matter as follows:

Community competition law should . . . not offer less efficient undertakings a safe haven against vigorous competition even from dominant undertakings. Different considerations may, however, apply where an undertaking which enjoys a position of dominance approaching a monopoly, particularly on a market on which price cuts can be implemented with relative autonomy from costs, implements a policy of selective price cutting with the demonstrable aim of eliminating all competition. In those circumstances, to accept that all selling above cost was automatically acceptable could enable the undertaking in question to eliminate all competition by pursuing a selective pricing policy which in the long run would permit it to increase prices and to deter potential future entrants for fear of receiving the same targeted treatment.¹¹²

The Advocate General continued:

To my mind, Article 86 [now Article 82] cannot be interpreted as permitting monopolists or quasi-monopolists to exploit the very significant market power which their superdominance confers so as to preclude the emergence either of a new or additional competitor. Where an undertaking, or group of undertakings whose conduct must be assessed collectively, enjoys a position of such overwhelming dominance verging on monopoly . . . it would not be consonant with the particularly onerous special obligation affecting such a dominant undertaking not to impair further the structure of the feeble existing competition for them to react, even to aggressive price competition from a new entrant, with a policy of targeted, selective, price cuts designed to eliminate that competitor. . . . [T]he mere fact that such prices are not pitched at a level that is actually (or can be shown to be) below total average (or long-run marginal) costs does not, to my mind, render legitimate the application of such a pricing policy.¹¹³

The recent judgment of the UK Competition Commission Appeal Tribunal in the *Napp Pharmaceutical* case was more ex-

111. *Compagnie Maritime Belge*, [2000] E.C.R. I-1410, para. 115.

112. *Id.* at I-1418.

113. *Id.* at I-1420-21.

pllicit on this point and even used the term “superdominance.”¹¹⁴ The Tribunal said:

We for our part accept and follow the opinion of Advocate General Fennelly in *Compagnie Maritime Belge* . . . that the special responsibility of a dominant undertaking is particularly onerous where it is a case of a quasi-monopolist enjoying ‘dominance approaching monopoly’, ‘superdominance’ or ‘overwhelming dominance approaching monopoly’ . . . Napp’s high and persistent market shares put Napp into the category of ‘dominance approaching monopoly’ — i.e., superdominance and the issue of abuse in this case has to be addressed in that specific context.¹¹⁵

Napp had maintained a market share over 90% and it was clear that it was selling at prices well below its costs. Therefore, there was no need to use the concept of “superdominance”: it was clear that it was committing an abuse under the *AKZO* principle. But the Tribunal went to some lengths to show that *Napp* also came within a broader principle found in *Irish Sugar* and *Compagnie Maritime Belge*. Napp had been selling its products below cost to hospitals, and was able to keep its competitors out of the much larger market segment for sales into the community (i.e., patients at home) if it could prevent competitors from selling to hospitals. Napp had therefore succeeded in keeping its competitors out of the gateway into the market, and therefore out of the whole market. Napp was “a virtual monopolist that has been selling at prices well below direct cost, and doing so selectively on those tablet strengths where it has faced competition.”¹¹⁶ The Tribunal said that *Compagnie Maritime Belge* and *Irish Sugar* show that:

even if the prices of a dominant firm remain above costs, and simply match the price of a competitor, there may still be an abuse, at least where a superdominant firm is concerned, if the reduced prices in question are made on a selective basis and have no economic rationale other than the elimination

114. Napp Pharm. Holdings Ltd. and Subsidiaries v. Dir. Gen. of Fair Trading, Case No. 1001/1/1/01, judgment of Jan. 15, 2002, available at <http://www.competition-commission.org.uk/appeals/current.htm>. Although this judgment applied UK law, the relevant section of the UK Competition Act is virtually identical to the wording of Article 82, and the Act requires that it is to be interpreted and applied in a manner consistent with Community competition law.

115. *Id.* at 55, para. 219.

116. *Id.* at 57, para. 225.

of competition.¹¹⁷

Later the Tribunal said:

Napp is a superdominant undertaking in both the hospital and community segments with, in consequence, a particularly onerous special responsibility 'not to impair further the structure of the feeble existing competition'. . . . Napp is a superdominant undertaking with well over 90% of the market. During the period of the infringement it had only one significant competitor. . . . Irish Sugar . . . shows that selective discounting by a dominant undertaking, without any economic justification, which tends to eliminate competition, is . . . an abuse.¹¹⁸

It is not easy to see the justification for the suggestion that companies with especially high market shares have additional duties not applicable to other dominant companies: what could they be? All dominant companies should be free to compete by legitimate means, and none should be allowed to compete by exclusionary means. The idea of superdominance does not help to distinguish between them, and does not (and could not) validly suggest that some pro-competitive practices become anticompetitive if the company adopting them has a high enough market share. Any concept of "superdominance" that is predicated on high market shares (whatever they are) also misses the point. High market shares are only meaningful if there are also very high barriers to entry; if not the market should be contestable and the dominant firm's market share eroded by new entry. The better way to understand these cases is that companies which are in very strong market positions are better placed and have greater incentives to eliminate new entrants entirely from the market. Companies which are dominant, but have less market power, are less likely to try or to be able to push their only competitor out. Clearly, however, if they did do so by unlawful means, that too would be an abuse. This means that "superdominance" is at best a concept that covers the probable effects of exclusionary conduct carried out by near-monopoly firms rather than a separate legal rule. The concept of "superdominance", if it was to be useful (which we doubt), would require both a definition of when it exists and a description of the addi-

117. *Id.* at 58, para. 230.

118. *Id.* at 87-88, paras. 337-39.

tional constraints which it would imply. There is no obvious basis, need or justification for either, and any attempt to invent them would complicate the law still further. In particular, it would be unfortunate if the idea of superdominance became accepted without clarification of the distinction between legitimate price competition and exclusionary practices. Legitimate price competition, which competition law exists to promote, can also eliminate competitors.

iii. Selectivity and intent

The final explanation — which we also reject — is that selectively low pricing and intent to eliminate a competitor render unlawful pricing that would otherwise be legal. Clearly, Community competition law attaches a great deal of importance to intent and the selective nature of the price-cutting in determining whether prices are predatory. The second *AKZO* rule states that prices above average variable cost but below average total cost may be considered predatory if they are “part of a plan to eliminate a competitor.” Similar presumptions are applied in the case of above-cost pricing that has been treated as exclusionary. In *Hilti*, the Commission found that above-cost selective price cuts were illegal because they were “designed purely to damage the business of, or deter market entry by, competitors, while maintaining higher prices for the bulk of its other customers, is both exploitative of these customers and destructive of competition.”¹¹⁹ Both Community Courts in *Compagnie Maritime Belge* attached importance to the fact that CEWAL had agreed a plan to “get rid of” its only competitor. The *BPB Industries*, *Napier Brown*, and *Irish Sugar* cases also noted that the selective (above-cost) prices were directed at competitors’ customers. This has led some commentators to conclude that the unlawful element is selectivity or the intent to injure a rival and that dominant firms’ pricing must be non-discriminatory to be lawful.¹²⁰

This cannot be right. First, there cannot be a *per se* non-discrimination rule for price-cutting above average variable cost. The second *AKZO* rule states that a plan to eliminate a competitor may be relevant to establish predation if prices are above average variable cost but below average total cost. But if prices are

119. *Hilti Decision*, O.J. L 65/19, para. 81 (1988).

120. See *Andrews*, *supra* n.59, at 53.

above average total cost, it cannot be the case that the same circumstance also means that those prices are abusive. If that were the case, the second *AKZO* rule would not be a rule relating to predatory pricing at all but a strict non-discrimination principle for all pricing carried out by dominant firms. For the reasons outlined above, there is not, nor should there be, any such rule.

Second, the “selectivity” of a price cut is not relevant in any economic sense if prices remain above cost. A selectively low price targeted at a competitor’s customers is the same thing as a generally low price offered by the dominant company. In either case, the effective price that the competitor has to face is the same. A dominant company may be able to sustain a price-cutting campaign longer if it only offers selectively low prices, but this can only be relevant, if at all, to below-cost prices, since above-cost prices are still incrementally profitable and do not need a subsidy from non-discounted sales. Unless the selectively low price is below cost, it is still a profitable price for the dominant company and will in nearly all cases be a price at which a competitor should be able to survive.

Third, all profit-maximizing companies “intend” to eliminate their rivals and the most obvious way of doing this is through price competition. It is almost impossible to distinguish between the “intent” that the antitrust laws should prohibit and the “intent” that they encourage. One U.S. Circuit Court vividly described the problems with penalizing intent as follows:

[F]irms “intend” to do all the business they can, to crush their rivals if they can . . . Rivalry is harsh, and consumers gain the most when firms slash costs to the bone and pare price down to cost, all in pursuit of more business. Few firms cut price unaware of what they are doing; price reductions are carried out in pursuit of sales, at others’ expense. Entrepreneurs who work hardest to cut their prices will do the most damage to their rivals, and they will see good in it. You cannot be a sensible business executive without understanding the link among prices, your firm’s success, and other firms’ distress. If courts use the vigorous, nasty pursuit of sales as evidence of a forbidden “intent,” they run the risk of penalizing the motive forces of competition.¹²¹

121. *A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc.*, 881 F.2d 1396, 1402 (7th Cir. 1989).

The Commission also seems to recognize these dangers, even if in practice they do not seem to have deterred it from treating prices above average variable cost as unlawful on the basis of circumstantial evidence of intent:

The Commission emphasizes that it does not consider an intention even by a dominant firm to prevail over its rivals as unlawful. A dominant firm is entitled to compete on the merits. Nor does the Commission suggest that larger producers should be under an obligation to refrain from competing vigorously with smaller competitors or new entrants.¹²²

Finally, antitrust enforcement that depends on circumstantial evidence of intent as a necessary legal condition is haphazard and risks using hyperbole as a basis for intervention. Inflammatory documents are easily concealed and more easily taken out of context.

c. Our Suggested Approach

Although there appears to be some view that prices above average variable cost exceptionally may be anticompetitive, it is hard to see how a clear legal rule could capture the relatively small number of situations in which that occurs. Condemning above-cost pricing should be approached with considerable reserve, since price competition is almost always desirable and it is very difficult, if not impossible, to formulate a legal rule to distinguish between an above-cost low price that will eliminate a competitor and one which will not. It is notable that the proponents of the theory that above-cost pricing can be exclusionary have not been able to formulate a satisfactory legal rule to that effect. Baumol's idea that the dominant firm should be required to maintain the low price for a period of eighteen months or so seems unworkable and an overreaction to the actual scope of the underlying problem. Edlin's idea that the dominant firm should be prevented from responding with substantial price cuts or significant product enhancements until the entrant becomes "viable" suffers from a similar problem and from definitional issues. Neither thesis could form the basis of any sensible legal rule. In our view, the only exception to the rule that pricing above average variable cost is always legal concerns situations where there is clear evidence of a cumulative pattern of other exclusionary

122. ECS/AKZO Decision, O.J. L 374/1, at 21, para. 81 (1985).

abuses in addition to low pricing. This exception would provide legal advisers with a workable framework. It is also consistent with the *AKZO* case, which states that prices above average variable cost but below average total cost may only be unlawful if they form “part of a plan to eliminate a competitor.”

2. The Legal Rules: The Need For Recoupment Under EU Law

One difference between EU and U.S. law on predatory pricing is that recoupment is not an element of the test in EU law. Some U.S. courts have held that, in addition to proving that the pricing complained of is below an appreciable measure of cost, there must be a reasonable prospect of recovering the losses incurred by the below-cost price through the dominant firm’s subsequently raising prices. In *Brooke Group*, the Supreme Court laid out a two-prong test for recoupment. First, “below-cost pricing must be capable . . . of producing the intended effects on the firm’s rivals, whether driving them from the market, or . . . causing them to raise their prices to supra-competitive levels.”¹²³ Such a determination is to be based on factors such as “the extent and duration of the alleged predations, the relative financial strength of the predator and its intended victim, and their respective incentives and will. The inquiry is whether, given the aggregate losses caused by the below-cost pricing, the intended target would likely succumb.”¹²⁴ Second, it must be shown that “the predatory scheme alleged would cause a rise in prices above a competitive level that would be sufficient to compensate for the amounts expended on the predations, including the time value of the money invested in it.”¹²⁵ This determination will depend on “an estimate of the cost of the alleged predation and the close analysis of both the scheme alleged by the plaintiff and the structure and conditions of the relevant market.”¹²⁶ If either element of recoupment is not possible, the claim fails. Factors such as new entry, the ability to expand capacity, and whether the market is diffuse will influence to what extent recoupment is possible.¹²⁷

123. *Brooke Group Ltd.*, 509 U.S. at 225.

124. *Id.*

125. *Id.*

126. *Id.* at 226.

127. *Id.*

Although not universally applied by the U.S. courts, the theoretical underpinnings of the recoupment test have much to commend them, even if, in practice, they constitute a considerable barrier to plaintiffs trying to establish a predatory pricing claim. The basic objection to predatory pricing implicitly assumes that the ability to recover losses will make short-term pricing cutting both anti-competitive and profitable because higher prices can be charged once market exit has been caused and rivals are deterred from entering again. If the price-cutting does not lead to some recovery by the dominant firm, this will in nearly all cases mean that rivals have been able to offset the effects of those price cuts or re-enter at a later stage, or that new entry is possible and will keep prices at competitive levels.

Reaction in the EU to the need to have recoupment as a legal condition has been mixed, but generally hostile. As explained above, in *Tetra Pak II*, the Court of Justice rejected the notion of recoupment as necessary, at least in so far as the egregious circumstances of that case were concerned. Likewise, the UK Competition Authority, the OFT, takes the position that recoupment is relevant only if a dominant firm uses revenues from a dominated market in order to engage in predatory conduct in a non-dominated market, i.e., in cases of cross-subsidization.¹²⁸ According to the OFT, if pricing below cost occurs in a dominated market, it can be assumed that the dominant firm can recoup losses afterwards.

More recent judicial statements have been supportive of the need for recoupment as a necessary legal condition for predatory pricing. In *CEWAL*, Advocate General Fennelly stated that recoupment was implicit in the Court of Justice's statements in *AKZO* and *Hoffman-La Roche* and that some form of recoupment "should be part of the test for abusively low pricing by dominant undertakings."¹²⁹ Indeed, in that case, the Advocate General stated that the sharing of losses resulting from the price-cutting among the *CEWAL* members was in essence a form of recoupment. This seems only partly correct. While loss-sharing may make it easier to share the cost of eliminating a competitor (the first limb of the recoupment test under U.S. law), it does not directly affect the possibility for supra-competitive prices to be

128. See OFT 414, *supra* n.47, at 16.

129. *Compagnie Maritime Belge*, E.C.R. I-1419, para. 136.

maintained thereafter (the second limb under U.S. law). That said, it seems reasonably clear from the CEWAL case that CEWAL's insistence on exclusive contracts, its 100% loyalty rebates, its reputation for taking significant retaliatory measures against its only competitor, and the high fixed costs that would have been incurred by a new entrant would have been sufficient to ensure that recoupment was feasible.

Likewise, in *AKZO* and *Tetra Pak II*, the companies concerned were dominant in a wide range of products but only engaged in selective price-cutting for one product that a competitor offered. Given their dominance in a wide portfolio of products, it was probable that the threat of retaliation against a rival supplying only one of those products was a credible deterrent that would have allowed recoupment because other rivals would have been dissuaded from entering. In other words, all cases in which predatory pricing was found under Community competition law seemed *prima facie* capable of supporting probable recoupment.

There are, however, reasons to treat a strict recoupment requirement with caution. First, it is often difficult to prove what the dominant company could do successfully at an unspecified time in the future. It would be necessary to show that there would be no entry by more competitive or more determined rivals, and that when the dominant company increased its price, it would not attract new entry. It would also be necessary to show that the price elasticity of the product was such that, although buyers were accustomed to low prices, they would be willing to pay significantly higher ones in the future. All of this suggests that the burden of proof is crucial. If the burden of proof was on the party alleging illegal low prices, it would make it difficult to bring a successful case. If the burden of proof was on the dominant company, it would be obliged to prove a negative, that is, to prove that it would be unable to recoup its losses if it tried to do so.

Second, predatory pricing by a dominant company may have anticompetitive effects even if the dominant company does not or could not recoup its losses. The most effective form of predatory pricing is one where a company discourages market entry, or causes exit, by signaling to actual or potential competitors that their profitability in the market in question will be low as long as the dominant company is price leader in that market.

This signaling would be more effective, and the effects of it would last longer, if the dominant company did not have to recover its losses, but held its prices only a little above competitive levels. This discouraging or signaling effect is particularly likely to be important if the dominant company is active on several markets, because predatory pricing on one market may discourage market entry on the others. This is particularly important in air transport, where predatory pricing, if it occurred on one route, would discourage entry on the other routes on which the dominant airline was operating.

Finally, predatory pricing may have anticompetitive effects even if the rival is not forced out of the market, but instead decides to raise its prices to approximately the prices of the dominant company. In particular, in a concentrated market predatory pricing may demonstrate the dominant company's ability and willingness to retaliate against aggressive pricing by a competitor, and so may give rise to oligopolistic pricing. In such circumstances it would be extremely difficult to prove that recoupment had occurred, even if it had.

In the circumstances, an express recoupment requirement might complicate the law further and impose an unfair burden on the party that bore that burden. Further, the absence of an express recoupment requirement does not, in our view, risk serious divergence between EU and U.S. law. In EU law, the prohibition on predatory pricing only applies to companies that are dominant. If a company is found dominant, that already suggests a high market share, a certain degree of immunity from normal competitive forces, and high barriers to entry in the relevant market concerned. An incumbent with a large share in such a market may be able to exclude new entrants effectively through below-cost price-cutting, particularly where there are large sunk costs or structural features of the market that require a minimum efficient entry or network effects. Thus, in many cases, the prevailing market conditions that contribute to dominance may also offer a good indication that rivals' exclusion will lead to anticompetitively high prices in the future, and that recoupment is therefore probable.

3. Defenses For Below-Cost Pricing

The Commission's decisional practice and the Community

Courts' case law have often assumed that the only explanation for below-cost pricing is predation. This seems overly restrictive, since there are a number of legitimate pro-competitive reasons for short-term below-cost selling. Different defenses apply depending on whether the price charged is above or below average variable cost.

a. Prices Below Average Variable Cost

Where the price charged is below average variable cost, it usually will be safe to assume that it is predatory, since a dominant firm will normally have no interest in charging such a price in the medium to long-term. However, a few defenses might still be applicable. The first is the principle established in the *General Motors* judgment, which suggests that it may be a defense if the company genuinely did not know the facts that showed that its price was unlawful and corrected the price as soon as it found out.¹³⁰ The second possible defense is that the dominant company is launching a product or service in a new market, and so inevitably the first sales, whatever the price charged, will not cover the average variable costs that are being incurred or have already been incurred. A defense on these lines must be permissible; otherwise dominant companies would be unable to enter new markets. The third possible defense is that the low price or free gift is a short-term promotion or trial offer made as a means of getting attention for the product or service in question. There is nevertheless an element of reasonableness for below-cost selling in the case of new markets or promotional offers: long-term or repeat promotional offers may be tantamount to predatory price-cutting. As the OFT states:

A dominant undertaking which adopts a one-off short-term promotion [below average variable costs for a limited period] is unlikely to be found in contravention of the Chapter II prohibition [abuse of a dominant position]. However, a series of short term promotions could, taken together, amount to a predatory strategy.¹³¹

In addition, the strategic objectives behind loss-leading are also important: price-cutting designed to exclude rivals' access to

130. See *General Motors Continental NV v Comm'n*, Case 26/75, [1975] E.C.R. 1367, 1380, paras. 20-21.

131. See OFT 414, *supra* n.47, at 12.

market “gateways” should be treated more harshly than loss-leading that is genuinely intended to allow consumers to test new products. A final defense might be that the product is being phased out. Some revenues are better than no revenues where fixed-cost recovery is concerned and the scope for exclusion in such circumstance is limited.

Loss-leading raises more difficult issues. Loss-leading is practiced by companies selling a number of products, and is designed to attract buyers to the seller in the expectation that, once the buyer is on the seller’s premises or committed to certain purchases anyway, the buyer will buy enough of other products to provide a profit greater than the loss on the product used as the loss leader. The most common example is probably food sold in a supermarket. Loss-leaders in these circumstances tend to involve different products on each occasion. But the same kind of issues are raised by a company which consistently sells capital equipment at a loss with a view to recovering the loss on subsequent sales of spare parts, consumables, or maintenance or repair services. In all these situations it seems that there is a valid defense if it is reasonable for the dominant company to expect that, as a result of the sale below cost, revenue will be obtained from other sales, which would not otherwise have been made, and that the expected or average additional revenue will exceed the amount of the loss. In other words, it is lawful to sell a system or combination of products in this way even if the initial sale is made at a loss (except, perhaps, where the same products are always sold at a loss and there is a rival which only produces that product). It would be useful to be able to show that competitors were able to use the same strategy if they wished, even if the competitors were clearly not subject to the obligations of dominant companies. However, if the competitors were not in a position to use the same strategy successfully, selling below cost in a market “gateway” might have serious exclusionary effects. This was the situation in the *Napp Pharmaceuticals* judgment of the UK Competition Appeal Tribunal discussed above.

Finally, the defense of meeting competition explained in detail in Part III above will also be applicable. Even dominant firms should be allowed to compete where there is a genuine price war with rivals. However, in the case of pricing below average variable cost, the dominant firm should be allowed to meet, but not undercut, the rival’s price. Otherwise, the dominant

firm could always put rivals out of business through predatory pricing by arguing that it was responding to a competitive offer. Moreover, unlike in the case of pricing above average variable cost, such a rule should not lead to price collusion between the dominant firm and its rivals: the dominant firm will not have any interest in agreeing on prices below average variable cost.

b. Price Above Average Variable Cost But
Below Average Total Cost

If the price in question is above average variable costs but below average total costs, different questions arise and a wider range of defenses will be available. Under the second *AKZO* rule, selling at such a price is lawful unless there is evidence of exclusionary intent. There may be several explanations other than predation for pricing above variable costs but below average total cost:

- As in the case of pricing below average variable cost, the dominant firm should be allowed to respond to competitive offers. However, unlike in the case of pricing below average variable cost, the dominant firm should be allowed not only to meet the rival's price but also to undercut it. Otherwise, there is a risk, for the reasons explained in Part III above, that the rival would benefit from a price floor and that the firms would be tempted to collude on pricing.
- The sale is being made during a period of reduced demand in which no supplier of the product or service is able to sell at a price sufficient to cover its average total costs. A dominant company in such circumstances must be free to sell what it can at whatever prices it can obtain, for cash-flow reasons. Loss-minimizing is also the basis for the defense that goods are being sold below average total costs because they are obsolete, deteriorating, or would cost so much to store until they could be sold at a higher price that the loss would be minimized by immediate sale. The principle of loss-minimizing or profit-maximizing is probably the principle applicable in one difficult and controversial type of situation, in which the marginal or average variable cost of each additional sale is near to zero, but the effect is that competitors can sell their products only with difficulty or not at all. If, however, this is the

effect of legitimate economies of scale or scope, a price at the average variable cost is not predatory, once the capital costs have been covered. Before they have been covered, the start-up defense may be applicable. Below cost pricing in these circumstances should not be regarded as predatory in the absence of some exclusionary intent. Even where there is exclusionary intent, it will be necessary to evaluate whether loss-minimizing or predation is the real reason for the low price.

- It should be a defense to show that the price in question, although below average total costs, was a loss-minimizing price at the time it was charged. A dominant company with high capital costs may be obliged to sell at prices well below its total costs for a substantial initial period until it reaches a certain scale of operations, or a minimum number of customers in a network industry.
- If product storage costs over the long-term would result in some selling below average total cost, it may be more rational to sell below average total cost immediately to make some saving.

All these defenses have to be assessed in light of the facts as they were known to the dominant company at the time it made the below-cost sale. If the price chosen was a reasonable and rational price to minimize losses at that time, the defense is valid even if, with hindsight, it appears that another strategy would have been more profitable or would have had less exclusionary effect. Similarly, a loss-leader sale is lawful if the information available to the company showed that on average it was probable that the loss incurred would be recovered from sales of other products or services, which would not have been made without the below-cost sale. The same principle applies to yield management by airlines, which leads them to sell the last seat on a plane just before it takes off for a minimal price because if they did not sell it at that price, the seat would be empty. In the case of yield management, as in the case of other sales of systems or loss-leaders leading to sales of other products, the price is not predatory unless the company is likely to make a loss overall.

Whether the above defenses should be available where the pricing is accompanied by other exclusionary practices will depend on the nature of those exclusionary practices and the defense claimed. If the other exclusionary practice is an exclusive

purchasing commitment, it will not be relevant to say that the dominant firm was responding to a competitive offer. Similarly, if there is evidence of tying practices in addition to price-cutting, it will not usually be a justification to argue that the dominant firm was responding to competitive threats in the market for the tied product. In contrast, where goods are obsolete, deteriorating, or would incur substantial storage costs if unsold, the fact that the discounted price is coupled with an exclusive purchasing commitment for the quantities in question should not invalidate the defense of loss-minimizing.

V. *CROSS-SUBSIDIES – A SPECIFIC CASE OF PREDATORY PRICING*

A. *Introductory Remarks*

Cross-subsidies are not mentioned in Article 82, and brief references in the case law of the Community Courts do not make clear when a cross-subsidy might be an abuse.¹³² In general terms, cross-subsidization occurs where a company uses funds generated from one area of activity to fund activities in another area of its activity. A cross-subsidy may give rise to an antitrust problem if the dominant company has a monopoly or near-monopoly position in one market, and also has activities in another related market where it is in competition with competitors who sell only in the second market. Competitors in the second market have to meet all the costs necessary for their production for that market (“stand-alone costs”). The horizontally integrated dominant company however has several kinds of costs. It has “incremental costs” which arise only because of its operations in the competitive market, and which would cease if its operations in that market ceased. It also has or is likely to have costs which are common to its operations in both markets, but which would be unaffected by cessation of its activities in the competitive market. It also has costs which arise only because of its operations in the market in which it has a monopoly. The problem for the competitor is that the dominant company is able to spread its common costs over two sets of operations instead of only one — in other words, it has economies of scale or scope.

132. See e.g. *Merci Convenzionali Porto di Genova SpA v. Siderugica Gabrielli SpA*, Case C-179/90, [1991] E.C.R. I-5889, para. 19.

Various approaches have been used to detect cross-subsidies, but there are essentially two approaches that should be mentioned. First, if the monopolist's prices in the second market cover the incremental cost of producing products in that market, there is no cross-subsidy. A second approach is to calculate the stand-alone cost of producing each output separately from other outputs: if the price for each output covers those costs, there is no cross-subsidy.

A number of regulatory issues are raised by cross-subsidies, particularly in the context of utilities and regulated markets, including the need for structural and accounting separation between reserved monopoly and competitive businesses. In the context of Article 82, it is assumed that cross-subsidy cases are in essence cases in which the abuse, if there is one, is predatory pricing.¹³³ Multi-product companies cross-subsidize all the time, whether or not they realize that they are doing so. There is no abuse of cross-subsidizing in the absence of predatory prices, since an above-cost price does not by definition need any subsidy. The important issue therefore under Article 82 is which costs must be taken into account in determining whether the lower price in the competitive market is predatory.

Two different approaches are possible. The approach which has always been understood to be the correct one is to require the dominant enterprise to allocate its common costs, on some appropriate basis, between the monopoly market and the competitive market. This would not deprive it of the benefit of economies of scope or scale, but would ensure that in other respects it would be competing on an equal footing in the competitive market. Its economies of scope would give it a legitimate

133. In *UPS Europe SA v. Comm'n (Deutsche Post AG, intervening)*, Case T-175/99, [2002] 5 C.M.L.R. 2, the Court of First Instance said that "the mere fact that an exclusive right is granted to an undertaking in order to guarantee that it provides a service of general economic interest does not preclude that undertaking from earning profits from the activities reserved to it or from extending its activities into non-reserved areas." *Id.* at para. 51. The Court went on (para. 55) to say that the use of profits from reserved activities to buy another company could raise problems where the funds used derived from excessive or discriminatory prices or from other unfair practices (that is, presumably, practices contrary to Article 82). In such a situation, it is necessary to look at the source of the funds to see if the purchase of the other company resulted from abuse of a dominant position. *Cf.* Criminal proceedings against Paul Corbeau, Case C-320/92, [1993] E.C.R. I-2533.

competitive advantage, but it could not use its internal cost allocation to create a barrier to entry into the competitive market.

The second approach is to essentially apply the *AKZO* rules to the competitive market only. If there is no evidence of a plan to eliminate a competitor, only average variable costs would be relevant; average total costs need not be calculated (and so there is little or no need to allocate common costs, because most common costs are fixed). In fact, if there are no incremental fixed costs, the *AKZO* average variable costs test and the pure incremental-costs-only test come to the same thing. However, the *AKZO* case was treated as involving only one product market, and the "cross-subsidy" which predatory prices always imply was within a single product market for a relatively short period. The *AKZO* case, in other words, is analogous to the case of the last seat on the airplane on a given flight, not to a situation in which a dominant company is operating in separate markets with some common costs. It would not therefore seem right to apply the *AKZO* test to a two-market situation and to apply it over a period of several years in circumstances where: (i) a large proportion of the dominant company's costs in the competitive market were common costs; and (ii) the dominant company's revenues in the competitive market were above its costs there only if that proportion was allocated exclusively to the uncompetitive market. It is obviously a weakness of the first *AKZO* test that it ignores all non-variable costs altogether, in spite of the fact that both the dominant company and its competitor will normally have some costs of this kind. In such circumstances the internal cost allocation by the dominant company could create a barrier to entry into the competitive market.

B. *The Case Law*

The issue of cross-subsidization has not been raised directly in any case before the Community Courts. The issue was raised indirectly in *Tetra Pak II*.¹³⁴ *Tetra Pak* was found to have committed a range of pricing and other abuses in two different but related markets; aseptic and non-aseptic machinery and cartons. *Tetra Pak*'s market shares in the aseptic and non-aseptic markets were approximately 90% and 50%, respectively. There were also

134. See *Tetra Pak II*, O.J. L 72/1 (1992), *on appeal Tetra Pak v. Comm'n*, Case T-83/91, [1994] E.C.R. II-755.

important associative links between these two markets. The Commission's case was that Tetra Pak had engaged in predatory pricing in relation to its Tetra Rex non-aseptic carton by pricing below average total cost. This finding assumed that Tetra Pak was able to incur losses in the non-aseptic sector by substantial profits made in the monopoly aseptic sector. Tetra Pak argued before the Community Courts that it had not engaged in cross-financing from the aseptic to the non-aseptic sector. The Court of First Instance did not rule on this point, but simply noted that the "application of Article 86 [now Article 82] of the Treaty . . . does not . . . depend on proof that there was cross-financing between the two sectors."¹³⁵

The issue has now been considered directly in the Commission's decision in *Deutsche Post*.¹³⁶ The case concerned a complaint brought by the international express parcel delivery company, UPS, against the incumbent German postal operator. The allegation was that Deutsche Post was using profits from its reserved monopoly in the reserved postal sector to cross-subsidize a loss-making business in the competitive parcel sector and to engage in predatory pricing. That complaint was upheld by the Commission, which found that the parcel service was operated at a substantial loss for several years. Without the cross-subsidies from the reserved area, Deutsche Post would not have been able to finance below-cost selling in the competitive parcel area for any length of time. The Commission prohibited Deutsche Post's sales below cost in the parcel area and ordered the structural separation of that business from the reserved area.

The case had several unusual and significant features. First, Deutsche Post had a statutory monopoly, and also a legal duty to provide a universal postal service throughout Germany at standard postal rates. For this purpose it was obliged to maintain an infrastructure, which it was able to use both for its monopoly and its competitive services, but no part of which involved an incremental cost of providing the competitive service. Second, some of the incremental costs of its competitive service were fixed costs. In other words, some of the infrastructure used in this

135. *Tetra Pak*, [1994] E.C.R. II-389, para. 186.

136. See *Deutsche Post*, O.J. L 125/27 (2001). See also European Commission, *Guidelines on the Application of the EEC Competition Rules in the Telecommunications Sector*, O.J. C-233/2, at 17 (1991) (predatory behavior as a result of cross-subsidisation).

service was distinct from the infrastructure which Deutsche Post needed and used for its universal service. Third, the Commission decided to use the concept of incremental costs in the competitive market. Fourth, Deutsche Post's incremental costs of providing the competitive service in 1990-1995 were above its revenue from that service: in other words, by this test its prices were predatory.

In condemning Deutsche Post's predatory pricing on the basis of cross-subsidization, the Commission made a number of important points:

- Cross-subsidization occurs where the earnings from a given service do not cover the incremental costs of providing that service and where there is another service or bundle of services, the earnings from which exceed the stand-alone costs.
- The service for which revenue exceeds stand-alone cost is the source of the cross-subsidy and the service in which revenue does not cover the incremental costs is its destination. A profitable reserved monopoly is likely to be a permanent source of funding, i.e., overall revenues in the reserved area exceed its stand-alone costs. This means that, when establishing whether the incremental costs incurred in providing a service in the competitive sector are covered, the additional costs of producing that service, incurred solely as a result of providing the service, must be distinguished from the common fixed costs, which are not incurred solely as a result of this service.
- The Commission decided that infrastructure that had to be maintained in order to provide the universal service could not be incremental (which was clearly correct). The Commission therefore decided that the cost of providing and maintaining the infrastructure needed for the universal service need not be divided between the monopoly and the competitive service, but could be attributed solely to the monopoly in calculating Deutsche Post's costs in the competitive market. The Commission did not take its analysis further because Deutsche Post's activities in the competitive market were still predatory.

C. Comments

1. Allocating Costs Between Two Operations

After much controversy in various industries, the *Deutsche Post* decision shows that in these rather unusual circumstances the dominant company is *not* required to allocate its common costs, on any basis, between its two kinds of operations. In other words, it may legally allocate all its common costs to its monopoly operations, even if they also benefit its competitive activities. If it does this, its costs in the competitive market will be only incremental costs, and these will be less than the stand-alone costs of its competitor (all other things being equal). How much less will depend on the extent of the economies of scope or synergies between the dominant company's two sets of operations.

Presumably the incremental-costs-only approach would have been seen to be wrong if Deutsche Post had used every post office for rent-free banking, insurance, and travel agency activities. Merely concluding that even by this standard there was predatory pricing may not have been enough, since if common costs had to be allocated the losses would have been much greater, and competitors' claims for compensation correspondingly larger; the quantum of predation is often important. The Commission's conclusion that all the common costs could be attributed to Deutsche Post's monopoly activities was due to its universal service obligation. In other words, the same conclusion would arguably not be reached in the case of a dominant enterprise with no universal service obligation, whether or not it has a statutory monopoly.

In the unusual case in which it has been used, this approach means that the problems of correctly allocating common costs between the two sets of activities does not arise, and the question of whether the dominant company's prices in the competitive market are predatory depends only on whether they are below its incremental costs in that market. The fact that the competitor in that market has not got the advantage of economies of scope may be a difficulty, a handicap or a barrier to entry, but it is not one created or aggravated by the dominant company (except in price squeeze cases). Indeed, even if the dominant company was obliged to allocate its common costs in some appropriate way between its two kinds of operations, the total costs attributable to its operations in the competitive market might still be

below the stand-alone costs of its competitor, since the dominant company would have economies of scope and the competitor would not.

Whether any such approach discourages a dominant company from entering a competitive market does not depend on the merits of the *Deutsche Post* decision. It depends, in essence, on whether the principle is subject to an exception of the kind always assumed to apply in predation cases, which accepts that a company's initial activities in a new market are likely to be unprofitable. (This question did not arise in *Deutsche Post*, as the company had lost money for five years, and had been in the competitive market before that.) Provided that an exception of this kind exists, the Commission's approach does not seem to discourage legitimate competition by dominant companies.¹³⁷

In the absence of a universal service obligation, however, the incremental-costs-only approach would be too favorable to the dominant company because it would create or legitimize a barrier to entry into the competitive market. In the absence of any objective criterion such as the universal service obligation, the dominant company would have too much freedom to decide which of its costs in the competitive market were incremental and which were not. A rule should not be adopted if its application would lie essentially within the discretion of the company to be bound by the rule. The dominant company's incremental costs (because they can include some fixed costs) are likely to be higher than the average variable costs of its operations in the competitive market. If it is accepted that the incremental-costs-only approach is not appropriate in the absence of a universal service obligation (or the equivalent for some other reason), then it seems that the right approach would be to require allocation of common costs on some appropriate basis. What the best basis should be will depend on the circumstances.

2. Which Costs Do You Allocate?

It is said that neither economics nor cost-accounting impose

137. See Mats A. Bergman, *A Prohibition Against Losses? The Commission's Deutsche Post Decision*, 2001 EUR. COMPETITION. L. REV. 351, 351-54 (2001). Bergman suggests that the decision "will curb competition on the merits. Taken to the extreme, this standard can be interpreted as a prohibition for a firm that holds a monopoly in one market to show red figures in competitive markets." *Id.* at 351. This seems incorrect, for the reason stated in the text.

one single "correct" method of cost allocation. This is no doubt true, but it does not follow that allocation, on some consistent and reasonable basis, is unnecessary or impossible (although it may be difficult), or that no common costs need to be attributed to the competitive activities. Unless there is a universal service obligation, the dominant company should allocate or apportion costs and can still get the benefit of the economies of scale or scope to which it is entitled. If, on any reasonable cost allocation method, its prices are above its costs, then the details of the cost allocation method are unimportant. This means that it is much easier for a complainant or regulator to argue a cross-subsidy case than a price squeeze case.

It has been pointed out that the most obvious basis for cost allocation, in proportion to turnover in the two sectors involved, is defective if the lower price is predatory because it results from an unlawful cross-subsidy. If this was the position, the cost allocation might have to be recalculated using a corrected turnover in the lower price sector. It might be important e.g., for the rights of injured competitors to claim compensation, to calculate the extent of predation accurately. However, cost allocation between malleable and related interoperable products in the software industry, where the marginal cost of selling another copy of an existing product is in any case almost zero, cannot solve the antitrust issues that arise.

There may be a real problem if the competitive market is not really an independent market, but is always and necessarily merely a by-product of the market in which the dominant company is dominant (that is, the competitive market is uneconomic except in combination with the other market). If this is the situation as a result of the inherent economics of the two markets, then the incremental-costs-only approach might be right, because the barrier to entry into the competitive market is due to the competitor's underlying need to enter the main market and not to the dominant company's cost allocation. But in this situation it would be necessary to prove objectively that independent activities in the competitive market were inherently uneconomic, and were not uneconomic for competitors only because of predatory pricing by the dominant company.

The fact that the dominant company has a statutory monopoly does not seem relevant to the question of abuse. It is the statutory duties, if any, of a dominant company which justify the

incremental-costs-only approach, not its statutory privileges. Whether it is legally impossible for a competitor to enter the monopoly market, and not merely very difficult or impossible for other reasons, should not alter the rule on the definition of abuse. If there is no statutory monopoly in a given market, entry by new competitors is always possible in theory, however unlikely, difficult or uneconomic it may be in fact. From an economic standpoint, an absolute legal impossibility is not very different from a near-impossibility for other reasons.

Finally, it is worth mentioning another, different, principle. The Community Courts have accepted that a statutory postal monopoly may be necessary because some services are inevitably loss-making and therefore require cross-subsidization so that the postal service can break even overall. However, they have made it clear that the monopoly is only justified if all the services in question are necessarily part of the core activities and no less restrictive solution can be found.¹³⁸ If they are distinct services, there is no justification for the monopoly applying to them, and the normal rules about cross-subsidies, whatever they are, would apply. This principle also confirms that a postal monopoly and related competitive services should be considered separately, and that neither should be allowed or required to cross-subsidize the other.

CONCLUSION

From the foregoing, it is apparent that much of Community competition law on pricing practices is concerned with the form of the pricing measure rather than its economic effect and implications for consumer welfare. Certain Commission statements also seem to create *per se* rules, or at least strong presumptions of illegality, against certain pricing practices. Much of Community competition law in this area proceeds from the wrong premise. Lower prices should in nearly all cases benefit from a strong presumption of legality. The situation should only be different

138. See *Corbeau*, [1993] E.C.R. I-2533; see also European Commission, Notice from the Commission on the application of the competition rules to the postal sector and on the assessment of certain state measures relating to postal services, O.J. C-39/2, at 10 (1998). Deutsche Post's overall profits were substantial, and this calls into question either the justification for its reserved monopoly or the effectiveness of the regulatory authority. See also *Ufex v. Comm'n*, Case T-613/97, [2000], *on appeal* Case C-94/01, La Poste.

where it is clear that, in the specific context of the market under consideration, they distort competition in some material way between customers or create a handicap for competitors that is not merely the result of the dominant company's offering a lower price. In our view, the Commission should clarify its position on pricing practices in a way that properly reflects current economic thinking and its recently-stated objectives of safeguarding consumer welfare rather than the position of competitors. In light of the wording of Article 82, there are strong arguments for saying that only the following pricing practices by dominant companies are *unlawful* under Article 82:

PRINCIPLE 1. Charging a lower price on condition that the customer buys exclusively from the dominant company will generally be contrary to Article 82(b).

Despite some statements to the contrary, there is no rule of Community competition law which prohibits a dominant company from agreeing to give a price reduction on condition that the customer buys at least a specified quantity during a specific period, or gives a reduced price for a quantity which both parties believe is likely to be the buyer's total requirements during the period. A basic distinction should be made between: (i) discounts that are generally available; and (ii) discounts that are individually negotiated with the customer in question. If the quantity or target is not individually negotiated with each buyer, it should normally be unobjectionable, since it cannot (except by coincidence) correspond to the buyer's total requirements. Even where the discount is individually negotiated with the customer, it is still necessary to further distinguish several situations:¹³⁹

- A dominant company should be free to grant a quantity rebate for all of a customer's purchases if that rebate is not conditional on that customer's not buying from third parties. This is simply an unconditional price reduction.
- A dominant company can grant a discount on *additional* purchases made by a customer above a certain

139. These situations assume that none of the discounts would lead to predatory pricing.

quantity; that is simply a pro-competitive price reduction, and the buyer would be free to buy the additional quantity from any other supplier which offered a more favorable price for that quantity.

- A price reduction given on a buyer's purchases from a dominant supplier in a given period, which is granted *only* on the condition that the total quantity exceeds a target figure should usually be regarded as pro-competitive. However, issues may arise in the context of target or loyalty rebates if a price reduction that is applicable for all or most of a customer's purchases from the dominant company for a certain period is likely to be lost if the customer buys from another source. The antitrust objection is that rebates of this kind can create strong marginal incentives for the customer not to make the additional purchases from a company other than the dominant firm so that, in practice, they amount to exclusive or near-exclusive purchasing commitments. Whether the target rebates gives rise to appreciable foreclosure is highly fact-specific and requires consideration of a series of factors, including: (i) the size of the discount; (ii) whether the discount increases in a linear manner, or in steps, and if so what the quantity is for each step; (iii) the structure of market demand and whether the rebate is share-stealing or market-growing in effect (i.e., barriers to entry to the emergence of new buyers); (iv) the length of the reference period; (v) whether the dominant firm is an unavoidable trading partner; and (vi) the proportion of the total market subject to the price reduction.

AVAILABLE DEFENSES. In the case of non-predatory discounting practices, the unlawful practice is *not* the lower price but the conditions on which it is available. This means that it usually will not be a defense to show that the lower price was matching or undercutting a competitor's price. However, several other defenses will be available. In cases of exclusive buying contracts contrary to Article 82(b), or where the conditions of sale impose a loss or penalty if the buyer buys from another supplier, it should be a defense that the seller was making a substantial investment in order to supply the

buyer, and this investment would be economic only if the buyer bought exclusively from the dominant company.

For other rebates, the following defenses will usually be available: (1) volume discounts/economies of scale; (2) reduced costs; (3) payment for services provided by the buyer; and (4) the lower price is a pro-competitive measure to help a class of companies, e.g., those starting up or making substantial investments. There is no requirement that the rebate in question should be justified by precise cost savings.

PRINCIPLE 2. Charging different prices in similar transactions to customers that compete with each other is only contrary to Article 82(c) if the price difference is so large that it creates a significant competitive disadvantage for the customers paying the higher price. There is otherwise no general prohibition on a dominant company's charging different prices for the same product. (Discrimination by a vertically-integrated dominant company against competitors in a downstream market that rely on the dominant company for some input is subject to different and stricter obligations than those applicable under Article 82(c).)

However, the situations in which a dominant company would have the ability or incentive to charge different prices for the same product to such an extent that they give rise to distortions of competition between end-users will in practice be rare. This means that Article 82(c) will mainly be relevant where State-owned or controlled enterprises discriminate against companies from other Member States. Article 82(c) is therefore much narrower in scope than the (much-criticized) price-discrimination provisions of the U.S. Robinson-Patman Act; in addition, there are defenses under Article 82(c) that are excluded by that Act.

AVAILABLE DEFENSES. As in the case of rebate practices, the following defenses are generally valid: (1) quantity rebates; (2) meeting or undercutting a competitor's price; (3) reduced costs; (4) payment for services provided by the buyer; and (5) start-up prices.

PRINCIPLE 3. Charging a price (whether selective or not)

which is below the dominant company's average variable cost of selling the kind of product or service in question will usually be contrary to Article 82(b) unless a defense is available.

AVAILABLE DEFENSES. In cases of prices below average variable costs, the following defenses are valid: (1) the dominant seller did not know that its price was below its average variable costs; (2) the sales in question were the seller's first sales in a new market, made before it could have covered its average variable costs; (3) the sale (or other transaction) is a short-term promotion or trial offer made to call attention to the product in question; and (4) the sale is a loss-leader, that is, it is made to attract customers who will in practice buy quantities of other products or services sufficient to compensate for the loss on the product or service sold below cost. This defense does not apply, however, if the product used regularly or for a significant period as the loss leader is the only product made by a competitor. Meeting competition should also be a defense, although the dominant firm should arguably only be allowed to meet, but not undercut, the lower price offered by a rival.

PRINCIPLE 4. Charging a price (whether selective or not) which is above the dominant firm's average variable cost should only be contrary to Article 82(b) if the price is linked with other clearly exclusionary conduct or is otherwise shown to be part of an unlawful plan to force a competitor out of the market.

AVAILABLE DEFENSES. In cases of prices below average total cost but above average variable cost, it should be a defense that the price was loss-minimizing or profit-maximizing in the circumstances at the time. The defense of meeting competition will also be available and the dominant firm should be allowed to meet and undercut a rival's offer, as long as the price remains above average variable cost.