EU COMPETITION LAW UPDATE

Guidance On The Commission's Enforcement Priorities In Applying Article 82 Ec Treaty To Abusive Exclusionary Conduct By Dominant Undertakings

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On December 3, 2008, the EU Commission's Directorate General for Competition ("DG Competition") published its Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings (the "Guidance").[1]

The Guidance represents the culmination of years of work by DG Competition and the EU Member States' competition authorities (the "NCAs"), publicly launched in December 2005 with the publication of DG Competition's Discussion Paper on the application of Article 82 EC to exclusionary abuses (the "Discussion Paper").[2] Completion of the Guidance was delayed by the need to await the judgment of the Court of First Instance in Microsoft's appeal of the Commission's 2004 decision imposing fines against Microsoft for violations of Article 82 EC and by disagreements over controversial areas such as the treatment of rebates. The Guidance is also more limited than originally anticipated. Nonetheless, the Guidance represents a commendable effort to establish a coherent economics-based framework for the analysis of exclusionary conduct under Article 82 EC.

The Guidance follows the U.S. Department of Justice's (the "DOJ's") report on the assessment of single-firm conduct under Section 2 of the Sherman Act, which was not supported by the Federal Trade Commission. DG Competition stated that the Guidance is a "step towards more convergence with the approach to unilateral conduct followed by some other jurisdictions, such as the U.S.", but noted that the DOJ's report

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1 See http://ec.europa.eu/comm/competition/antitrust/art82/guidance.pdf See also Press Release of the Commission http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1877&format=HTML&aged=0&language=EN&guiLanguage=en

2 See DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses, December 19, 2005.

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differs from the Guidance on a number of issues, such as the appropriate balancing of pro- and anticompetitive effects of unilateral conduct, the role of market shares in assessing dominance, and the assessment of pricing conduct. Together, however, the Guidance and the DOJ report reflect the importance antitrust enforcement agencies attach to the assessment of unilateral conduct in the wake of a series of high-profile cases, including the Microsoft, Rambus and Qualcomm sagas.

This memorandum summarizes the main points of the Guidance in Part I and provides a more detailed analysis in Part II.

I. SUMMARY

According to the Guidance, in establishing its Article 82 EC enforcement priorities, the Commission will apply an "economic and effects-based approach to exclusionary conduct". The Guidance describes the Commission's general approach to exclusionary conduct, including how the Commission will determine whether a company accused of violating Article 82 EC has a dominant position and how the Commission will seek to determine whether the conduct in question has or is likely to result in anticompetitive foreclosure. The Guidance discusses the application of this analysis to four categories of conduct: exclusive dealing; tying and bundling; predation; and refusals to supply and margin squeezes.

Highlights of the Guidance, discussed in more detail below, include the following:

- Effect. The Guidance is not a statement of the law, but of DG Competition's enforcement priorities. DG Competition points out that the Guidance does not bind the European Courts. Less self-evidently, the Guidance does not bind NCAs and Member State courts, which, since Regulation 1/2003 entered into force, have the authority and the obligation to enforce Article 82 EC in parallel with the Commission. Nonetheless, NCAs and Member State courts can be expected to look to the Guidance to provide a framework for their analysis of alleged Article 82 EC violations, especially in view of DG Competition's extensive consultations with NCAs over the past three years.

- Scope. The Guidance covers only exclusionary abuses. It does not discuss so-called "exploitative" abuses, such as excessive pricing and discriminatory conduct. The Guidance also discusses abuses only in the context of single-firm conduct, missing an opportunity to clarify DG Competition's approach to exclusionary conduct by one or more companies holding a collective dominant position.

- Dominant position. The Guidance clarifies DG Competition's multi-factor analysis of whether a company holds a dominant position. As a first indication, DG Competition will look at the allegedly dominant company's market shares, taking into account market conditions, in particular market dynamics, product differentiation and market share trends over time. The Guidance sets out a "soft" market share safe harbor of 40%, below which a company is unlikely to be considered dominant. Other factors include barriers to entry or expansion in the relevant market and countervailing buyer power.

- Anti-competitive foreclosure. After determining that a company has a dominant position, DG Competition will examine whether the conduct in question has resulted or is likely to result in "anti-competitive foreclosure", in which actual or potential competitors' access to suppliers or markets is hampered or eliminated and the dominant company is likely to be in a position profitably to increase prices to the detriment of consumers.

- Equally efficient competitor test. In the case of price-based exclusionary conduct (in particular rebates, predatory pricing and margin squeezes), DG Competition will apply the so-called "equally efficient competitor" test to evaluate the foreclosure effect of challenged conduct. In these cases, DG Competition will seek to determine whether the dominant company's effective prices are above or below an appropriate cost measure, average avoidable cost ("AAC") or long-run average incremental cost ("LRAIC"). The Guidance's discussion of this analysis is simpler and more concise than the Discussion Paper's, but it also recognizes that the data for such an analysis may not always be available.

- Defenses. Otherwise abusive conduct will not violate Article 82 EC where the dominant company can show that its conduct results in efficiencies that outweigh the competitive harm from its conduct or that its conduct is justified by objective necessity. Unlike the Discussion Paper, the Guidance does not rule out the possibility that a defense can be made out for any type of conduct covered by the Guidance, though an efficiency defense is unlikely to be accepted for predatory conduct or conduct that creates or strengthens a monopoly or near monopoly.

- Quasi-*per se* abuses. Nonetheless, the Guidance identifies categories of behavior that are virtually *per se* abuses, in that to find a violation DG Competition will not need to conduct a detailed assessment of the conduct's effect (*e.g.*, a dominant company preventing its customers from testing a

competitor's products or paying a distributor or customer to delay introduction of such products) or for which no defense is likely to be accepted (*e.g.*, as noted, predatory conduct).

II. BACKGROUND AND ANALYSIS

A. BACKGROUND

The Guidance is a significant step in the Commission's efforts to provide more systematic guidance regarding the application of Article 82 EC. On December 19, 2005, the Commission published the Discussion Paper on the application of Article 82 EC to exclusionary abuses. The Commission received more than 100 comments on the Discussion Paper.[3] The Discussion Paper was controversial not only with companies and the antitrust bar, but also with NCAs. Since 2005, the Commission has been working with NCAs to reach agreement on a common framework. During this period, there were rumors that no guidance would be published owing to disagreements between DG Competition and the NCAs. The Guidance is in fact more limited than originally anticipated in the Discussion Paper; in particular, it does not cover exploitative abuses or exclusionary abuses in situations of collective dominance. On the other hand, the Guidance represents a welcome effort to put DG Competition's enforcement of Article 82 EC on a firmer economics-based footing than in the past and to link enforcement priorities to actual and likely harm to consumers.

Although DG Competition cautions that the Guidance is not a statement of law, but only a description of the Commission's priorities when applying Article 82 EC to exclusionary conduct,[4] the Guidance appears more ambitious than that. The Guidance summarizes much of the existing case law on the application of Article 82 EC to exclusionary abuses and attempts to place these precedents in a coherent analytical framework. Although DG Competition stresses that the Guidance is without prejudice to the Community Courts' case law, the Commission presumably hopes that in future cases the Community Courts will follow the Commission's approach. Of course, the Guidance is also not binding on NCAs or Member State courts, but again DG Competition expects, following the extensive consultations on the Guidance, that the NCAs and, hopefully, Member State courts, will also draw inspiration from the Guidance.

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3 See http://ec.europa.eu/comm/competition/antitrust/art82/contributions.html

4 See Guidance, § 3.

B. DOMINANCE

The Commission confirms the well-established definition of dominance, namely the power of a dominant company to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers.[5]

The Guidance elaborates on the classic factors indicating dominance: market shares, barriers to entry and expansion by competitors, and countervailing buyer power.[6]

- Market shares. The Guidance describes market shares as a "useful first indication" of the market structure and the relative importance of market participants. The Guidance stresses that market shares must be interpreted in light of market conditions, including market dynamics (notably changes in shares over time in volatile or bidding markets) and the degree of product differentiation.[7] The Guidance also confirms that a company is unlikely to be considered dominant if its market share is less than 40%.[8] Although this level is only a "soft" safe harbor, the Guidance suggests that companies with lower shares will be found dominant only in specific cases where competitors are not in a position to constrain their conduct, for example where competitors face serious capacity limitations.

- Barriers to entry and expansion. Low barriers to entry or expansion by actual or potential competitors can deter a company from raising prices if expansion or entry would be likely, timely and sufficient. Barriers to entry can include not only legal barriers, but also advantages peculiar to the dominant company, such as economies of scale and scope; "privileged" access to essential inputs, resources, or technologies; or an established distribution or sales network, even where these barriers are created by the company itself, for example through significant investments or long-term customer contracts that have appreciable foreclosure effects.[9]

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5 See Guidance, § 10.

6 See Guidance, §§ 12-18.

7 See Guidance, § 13. Regarding this approach, see also Guidelines on the assessment of significant market power under the Community regulatory framework for electronic communications, networks and services [2002] OJ C165/15, § 75.

8 See Guidance, § 14; See *Virgin/BA* [2000] OJ L 30/1, confirmed by Case T-219/99, *British Airways plc v. Commission* [2003] ECR-II 5917.

9 See Guidance, §§ 16-17.

- Countervailing buyer power. Countervailing buyer power may result from customers' size or their commercial significance for the otherwise dominant company and their ability to switch quickly between competing suppliers, to promote new entry or to vertically integrate (or credibly to threaten to do so). Countervailing buyer power may deter or defeat an effort to increase prices, but buyer power will not be considered an effective constraint if it shields only a particular or limited segment of customers.[10]

C. ANTICOMPETITIVE FORECLOSURE

The Commission's Article 82 EC enforcement policy is intended to protect consumers by ensuring that dominant companies do not foreclose competitors in an anticompetitive way, with an adverse effect on consumer welfare in the form of higher prices, quality limitations or reductions in consumer choice.[11] The Guidance states that DG Competition will consider not only harm to final consumers, but also harm to intermediate consumers, such as distributors and producers that use the products as an input.[12]

The Commission will normally only intervene under Article 82 EC where, based on "cogent and convincing evidence", the allegedly abusive conduct is likely to lead to anticompetitive foreclosure. DG Competition will consider the following factors in its assessment[13]:

- Strength of dominant position. The stronger the dominant position, the higher the likelihood of anticompetitive foreclosure.

- Market conditions. These include barriers to entry and expansion, the existence of economies of scale or scope, and network effects, which might allow a dominant undertaking to "tip" a market or to further entrench its position.

- Position of competitors. A competitor with even a small market share can play a significant competitive role, for example if it is the closest competitor, if it is particularly innovative, or if it has the reputation of systematically cutting prices.

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[10] See Guidance, § 18.

[11] See Guidance, §§ 1 and 19.

[12] See Guidance, § 19, footnote 15.

[13] See Guidance, § 20.

- Position of customers and suppliers. The likelihood of anticompetitive foreclosure will be greater where the dominant company is able to apply the practice in question selectively. Conduct directed at customers may have a greater foreclosure effect if it targets customers who are most likely to respond to offers from alternative suppliers; who represent a means of distributing products that would be suitable for a new entrant; who may be situated in a geographic area well suited to new entry; or who may be likely to influence the behavior of other customers. Exclusive supply arrangements may have a greater foreclosure effect if targeted at suppliers who might be most likely to respond to requests by competitors of the dominant firm or who would otherwise be particularly suitable suppliers for a new entrant competing with the dominant company (*e.g.*, based on location or the characteristics of the supplier's products).

- Extent of abusive conduct. The higher the proportion of total sales affected by the challenged conduct, the longer the duration, and the greater the regularity with which it is applied, the greater is the likely foreclosure effect.

- Evidence. The anticompetitive foreclosure effect of challenged conduct may be evidenced by the market performance of the dominant firm, if the conduct has been in place for a sufficient period of time. Otherwise, direct evidence of the dominant firm's strategy may help to interpret the conduct in question.

D. EQUALLY EFFICIENT COMPETITOR TEST

In the case of price-based conduct (in particular, rebates, predatory pricing and margin squeezes) the Commission uses the "equally efficient competitor" test to avoid deterring conduct that would not foreclose a competitor that is as efficient as the dominant company. DG Competition will not normally challenge conduct that would not hamper competition from a hypothetical competitor whose costs – measured by AAC or LRAIC – would be equal to those of the dominant company. If the data clearly suggest that the challenged conduct has the potential to foreclose competition by equally efficient competitors, the Commission will integrate this conclusion into the general assessment of anticompetitive foreclosure, as discussed above.[14]

In a qualification likely to draw criticism, the Guidance notes that constraints exerted by less efficient competitors should also be taken into account, in particular

[14] See Guidance, § 22.

where the dominant company's efficiency benefits from demand-related advantages such as network and learning effects.[15]

Application of the equally efficient competitor test depends on economic data on cost and sales prices of the dominant undertaking. If no such data are available, the Commission may use cost data of competitors or other comparable reliable data.[16] Under the Guidance, therefore, dominant companies will have a strong incentive to make their data available to the Commission to avoid the risk that the Commission will determine AAC or LRAIC based on cost data of less efficient competitors.

The application of this test to specific types of abuse is discussed below.

E. DEFENSES

A major difference between Article 81 and Article 82 EC is the possibility in Article 81 EC of justifying conduct violating Article 81(1) EC based on the efficiency criteria set out in Article 81(3) EC. Although the case law of the Court of Justice allowed certain justifications for violations of Article 82 EC,[17] Article 82 EC has no analogue to Article 81(3) EC. The Guidance now explicitly recognizes "efficiency" and "objective necessity" defenses for conduct that would otherwise violate Article 82 EC. The burden of proving both defenses falls on the dominant firm.[18]

To justify otherwise abusive conduct based on efficiencies, such as technical improvements in the quality of goods or reductions in the cost of their production or distribution, a dominant firm must show that:

- The efficiencies have been or are likely to be realized as a result of the conduct;

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15 See Guidance, § 23.

16 See Guidance, § 24.

17 See Case 27/76 *United Brands v. Commission* [1978] ECR 207, §184; Case 311/84 *Centre Belge d' etudes de marché – Télémarketing (CBEM) v. Compagnie Luxembourgeoise de télédiffusion (CLT) and Information publicité Benelux (IPB)* [1985] ECR 3261, §27; Case T-30/89 *Hilti v. Commssion* [1991] ECR II-1439, §§102-119; Case T-83/91 *Tetra Pak International v. Commission (Tetra Pak II)* [1994] ECR II-755, §§136 and 207; Case C-95/04 P *British Airways v. Commission* [2007] ECR I-2331, §§ 69 and 86.

18 See Guidance, § 30.

- The conduct is indispensable to the realization of these efficiencies – there must be no less anti-competitive alternatives capable of producing the same efficiencies;

- The likely efficiencies outweigh any likely negative effects on competition and consumer welfare; and

- The conduct does not eliminate effective competition by removing all or most sources of actual or potential competition – conduct that creates or strengthens a monopoly or near monopoly can normally not be justified by efficiencies.[19]

Regarding the "objective necessity" defense, the Guidance recognizes that exclusionary conduct can be justified based on external factors such as health or safety requirements related to the products in question. The Guidance notes, however, that public authorities, not private companies, are normally responsible for setting and enforcing public health and safety standards, signaling that DG Competition will look skeptically on claims that health or safety concerns justify exclusionary conduct that would otherwise violate Article 82 EC.[20] Indeed, the Guidance does not discuss objective necessity as a possible defense in connection with any specific form of exclusionary conduct covered by the Guidance.

F. SPECIFIC FORMS OF ABUSE

In addition to the general framework outlined above, the Guidance discusses DG Competition's approach to four categories of potentially abusive conduct: exclusive dealing; tying and bundling; predation; and refusals to supply and margin squeezes.

1. Exclusive Dealing

The notion of exclusive dealing includes various forms of conduct designed to foreclose competitors by hindering them from selling to customers. The Guidance focuses on two categories of exclusive dealing: entering into exclusive purchasing arrangements and granting conditional rebates.[21]

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19 See Guidance, § 29.

20 See Guidance, § 28.

21 The Guidance does not discuss rebates that are not conditioned on reaching certain volume targets, suggesting that only conditional rebates are considered to be a concern.

a. Exclusive Purchasing

The simplest form of exclusive dealing is an agreement in which the buyer agrees to purchase the contract goods exclusively or to a large extent only from the dominant company. When buyers agree to exclusive purchasing arrangements, they normally negotiate a compensation for the loss of competition. The fact that individual customers negotiate lower prices under exclusive purchasing contracts does not mean, however, that such arrangements are beneficial for customers as a whole or for final consumers. DG Competition will focus on situations where consumers as a whole will not benefit from exclusive purchasing.[22]

The Guidance highlights the following factors as particularly relevant for the analysis of exclusive purchasing arrangements:[23]

- Effect on potential entrants or on rivals that cannot compete for the customer's entire demand. Exclusive purchasing arrangements may result in anticompetitive foreclosure where important competitive constraints would otherwise be exercised by potential entrants or by competitors that are not in a position to compete for the customer's entire demand (for example, because the dominant company is an "unavoidable trading partner" (*e.g.*, its products are a "must stock" item) or because rivals suffer from capacity constraints); and

- Duration. The longer the duration of an exclusive purchasing obligation, the greater the likely foreclosure effect (although where the dominant company is an unavoidable trading partner, even a short-lived exclusive purchasing agreement can lead to anticompetitive foreclosure).

b. Conditional Rebates

Conditional rebates are rebates that reward particular forms of purchasing behavior if a customer's purchases exceed a certain threshold. Rebates applied to all purchases are known as "retroactive rebates," while rebates applied only to purchases over the threshold are known as "incremental rebates." DG Competition considers that, unlike predatory pricing, conditional rebates can have an anticompetitive foreclosure effect even without a profit sacrifice by the dominant company.

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22 See Guidance, § 33.

23 See Guidance, § 35.

The Guidance highlights the following factors as particularly relevant for the analysis of conditional rebates:[24]

- Effect on rivals that cannot compete for the customer's entire demand. Where competitors are not able to compete on equal terms for the customer's entire demand, a dominant company can use the "non-contestable" portion of the demand as leverage to decrease the price paid for the "contestable" portion.

- Retroactive vs. incremental rebates. Retroactive rebates are more likely to lead to anticompetitive foreclosure. The higher the rebate as a potential of the total price and the higher the threshold the greater the foreclosure effect.

- Individual vs. standardized thresholds. Individualized thresholds are more likely to lead to an anticompetitive effect than standardized thresholds, though if a standardized threshold approximates the requirements of an appreciable portion of customers, it may still result in anticompetitive foreclosure.

- Equally efficient competitor test. In the conditional rebate context, DG Competition will attempt to calculate the "effective price" that a competitor would have to offer to compensate the customer for the loss of the conditional rebate if the customer switched part of its demand, known as the "relevant range," from the dominant company to the competitor.

    - The effective price is not the dominant company's average price, but the dominant company's list price less the rebate the customer loses by switching, calculated over the relevant range.

    - For incremental rebates, the relevant range is normally the incremental purchases over the rebate threshold. For retroactive rebates, the Guidance says that it will be relevant to assess how much of the customer's purchase requirements the customer can realistically be switched to a rival (the "contestable share" or "contestable portion"). The contestable portion in turn may depend, on the customer's side, on the quantities it must in any event purchase from the dominant company (for instance, because its products are a "must stock" item) and, on the supplier's side, on capacity constraints or, for potential entrants, on the scale at which a new entrant could realistically enter the market.

[24] See Guidance, §§ 38-44.

- If the effective price is consistently above the dominant company's LRAIC, the rebate will normally not lead to anticompetitive foreclosure. Where the effective price is below AAC, the rebate is capable of leading to anticompetitive foreclosure. When the effective price is between these two levels, DG Competition will look at other factors, such as whether realistic and effective counterstrategies are available to rivals.

c. ***Efficiencies***

Dominant companies may defend exclusionary dealing that would otherwise violate Article 82 EC on the grounds that they achieve cost or other advantages that are passed on to customers. Exclusive dealing arrangements are more likely to result in advantages to particular customers if those arrangements are necessary for the dominant company to make certain relationship-specific investments. In the rebate context, transaction-related cost advantages are more likely to be achieved with standardized volume targets, and incremental rebates are more likely to give resellers an incentive to produce and sell higher volumes of products.[25]

d. ***Comments***

The Guidance's approach to exclusive dealing is an improvement over the formalistic approach of some of the Community Courts' precedents with regards to exclusive purchasing agreements and rebates. Nonetheless, the Guidance suffers from several limitations.

As noted, the Guidelines do not supersede the Community Courts' overly restrictive case law, but merely indicate DG Competition's enforcement priorities.

Furthermore, the application of the equally efficient competitor test to retroactive rebates is complex and confusing. For example, the Guidance defines the relevant range as the share of a customer's purchases that the customer is likely to switch, an amount that is difficult if not impossible to verify with any certainty. In the case of retroactive rebates, the Guidance introduces the concept of contestable share, though it is not clear how this concept helps to determine the relevant range. To enhance legal certainty, the Guidance should have specified that in the absence of clear evidence to the contrary, the relevant range will be considered to be 100% of the customer's purchases from the dominant company.

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[25] See Guidance, § 45.

More generally, the Guidance appears to have been drafted for the benefit of DG Competition and other authorities evaluating alleged violations. The test would be difficult, if not impossible, for a potentially dominant company to use in developing its rebate schemes to avoid possible violations. For example, a dominant company could not determine the "contestable share", the "relevant range" or the "effective price" without confidential information about its customers and rivals that it is unlikely to have.

2. Tying and Bundling

The Guidance acknowledges that tying (whether contractual or technical) and bundling (whether "pure" bundling, in which products are only sold jointly and in fixed proportions, or "mixed bundling", also known as "multi-product rebates") are common practices aimed at providing customers with better products in more cost-effective ways. DG Competition will normally take action only where a dominant company is dominant in one relevant market (the "tying market"), the other products involved (the "tied products") are distinct products, and the tying practice is likely to lead to anticompetitive foreclosure.

a. Distinct Products

Two products are considered distinct if, absent tying or bundling, a substantial number of customers would purchase the tying product without buying the tied product from the same supplier.[26]

b. Anticompetitive Foreclosure

The Guidance notes that the risk of anticompetitive foreclosure is greater:[27]

- Where the tying or bundling is lasting, for example through technical tying, which is costly to reverse and reduces the opportunities for resale of individual components;
- Where the company in question has dominant positions in more than one product in a bundle; and
- The more products are included in the bundle, particularly if the bundle is difficult for a competitor to replicate, either alone or in combination with others.

[26] See Guidance, § 50.

[27] See Guidance, §§ 51-57.

c. Multi-product Rebates and the Equally Efficient Competitor Test

DG Competition will apply the equally efficient competitor test when evaluating the anticompetitive foreclosure effect of multi-product rebates, using the incremental price customers paid for products in the bundle. If the incremental price for each product in the bundle is above the dominant firm's LRAIC from including the product, DG Competition will not normally intervene, since an equally efficient competitor offering only that product could in principle compete profitably. Enforcement action may be warranted if the dominant company's incremental price from including the product is below its LRAIC, since in such a case even an equally efficient competitor could be prevented from expanding or entering the market.[28]

If competitors are or could timely offer an identical bundle, the question becomes whether the price for the entire bundle is predatory (see below).[29]

d. Efficiencies

The Guidance recognizes a number of benefits that might support an efficiency defense in a tying or bundling case:[30]

- Savings in production or distribution;
- Reductions in transaction costs;
- Savings on packaging and distribution;
- Enhancing the ability to bring a new product to market through technical tying; or
- Savings from the production or purchase of large quantities of the tied product.

e. Comments

The case law of the Commission and the Community Courts with regards to tying and bundling, like the case law on single-product rebates, has been heavily criticized. The Guidance's more flexible approach is an improvement, but it is still very restrictive and does not contribute to legal certainty, since the Guidance's test will be difficult if not

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28 See Guidance, §§ 58-59.

29 See Guidance, § 60.

30 See Guidance, § 61.

impossible for dominant companies to apply for planning purposes. Moreover, it remains to be seen whether the Community Courts will adopt the Guidance's analytical framework.

3. <u>Predation</u>

The Guidance states that DG Competition will generally intervene in predation cases where there is evidence showing a dominant company is deliberately incurring losses or foregoing profits in the short term (referred to as "sacrifice"), so as to foreclose or be likely to foreclose one or more actual or potential competitors to strengthen or maintain its market power, thereby causing consumer harm. DG Competition may pursue predatory practices by dominant companies on secondary markets on which they are not yet dominant, especially in sectors protected by a legal monopoly.

a. Sacrifice

Pricing below the dominant company's AAC will in most cases be viewed as a clear indication of sacrifice. In addition to pricing below AAC, however, the concept of sacrifice involves whether the dominant company has a predatory strategy. In this regard, DG Competition may also investigate whether the alleged predatory conduct led in the short term to net revenues lower than could have been expected from reasonable alternative conduct. A predatory strategy may also be shown by direct evidence such as documents showing a detailed plan to sacrifice to exclude a rival, prevent entry or preempt the emergence of a market.[31]

b. Anticompetitive Foreclosure and the Equally Efficient Competitor Test

The Guidance recognizes a number of other factors relevant to the assessment of anticompetitive foreclosure. The risk of foreclosure will be greater where:[32]

- The dominant company is better informed about costs or other market conditions;
- The dominant firm can distort market signals about profitability to deter entry;
- The dominant firm has a reputation for predatory conduct;

[31] See Guidance, § 64.

[32] See Guidance, §§ 67 and 71.

- The targeted competitor is dependent on external financing; or
- The dominant company selectively targets specific customers with low prices.

If sufficient data are available, DG Competition will apply the equally efficient competitor test to determine whether the conduct is capable of harming consumers. The Guidance notes that predatory pricing will normally be capable of foreclosing equally efficient competitors.

Consumers are generally likely to be harmed if the dominant undertaking can reasonably expect its market power after the predatory conduct comes to an end to be greater than would have been the case absent the conduct; *i.e.*, if the company is likely to be in a position to benefit from the sacrifice, either by being able to increase its prices or to prevent or delay a decline in prices. Low prices applied generally for a long period of time are unlikely to be predatory.[33]

c. Efficiencies

In general, predation is unlikely to create efficiencies, but the Guidance does not completely rule out the possibility that low pricing enables the dominant company to achieve economies of scale or efficiencies relating to expanding the market.[34]

d. Comments

The Guidance's use of AAC as the starting point for its predatory pricing analysis breaks with current case law, which provides that prices are presumed to be predatory if they are lower than average variable costs ("AVC"). Under *AKZO*, prices above AVC, but below average total costs ("ATC"), are abusive "if they are determined as part of a plan for eliminating a competitor".[35] The Guidance states that "[i]n most cases the average variable cost (AVC) and AAC will be the same, as often only variable costs can be avoided."[36] Where AVC and AAC differ, the Guidance says that AAC is a better test; "if the dominant firm had to expand capacity in order to be able to predate, then the sunk costs of this extra capacity should be taken into account in looking at the dominant undertaking's losses. These costs would be reflected in the AAC, but not the AVC."[37]

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33 See Guidance, §§ 69-72.

34 See Guidance, § 73.

35 See Case C-62/86 *AKZO Chemie BV v. Commission* [1991] ECR I-3359, §§ 71 and 72.

36 See Guidance, § 63, footnote 40.

37 See Guidance, § 63, footnote 40.

However, it is unlikely that a dominant firm would invest in extra capacity in order to predate.

The Guidance notes that the concept of sacrifice includes not just pricing below AAC; DG Competition may also investigate whether the dominant company incurred a loss it could have avoided through reasonable alternative conduct. In context, it appears that DG Competition will only pursue a predatory pricing case if the dominant company is pricing its products below AAC, and even in such cases pricing will not be considered predatory if the dominant company appears to have taken reasonable steps to minimize its losses. The Guidance is, however, not clear on this point.

While the Guidance does not embrace the U.S. law requirement that a dominant company charged with predatory pricing will likely be able to recoup its losses, the Guidance's focus on likely consumer harm as an element of a predation case is a step in that direction.

The Guidance's application of the equally efficient competitor test, using the dominant company's LRAIC as a benchmark, is unpersuasive, since pricing below AAC is an element of a predatory pricing case and LRAIC will normally be above AAC. It is interesting that the Guidance, unlike the Discussion Paper, does not limit the use of the LRAIC standard to network industries and recently liberalized markets.[38]

4. <u>Refusal to Supply and Margin Squeezes</u>

The Guidance reflects DG Competition's cautious approach to refusal to supply cases, since any company, dominant or not, should have the right to choose its trading partners and to dispose freely of its property. An obligation to supply, even for fair remuneration, may undermine firms' incentive to invest and innovate. Competitors may also be tempted to free ride on dominant companies' investments instead of investing themselves.[39]

The Guidance notes that competition problems typically arise when the dominant company competes in the downstream market with the buyer whom it refuses to supply. The Guidance thus discusses refusals to supply and margin squeezes only where the dominant company is vertically integrated. The Guidance also does not discuss conduct in which supply is made conditional upon the buyer accepting limitations on its conduct

[38] See Guidance, §§ 66-67.

[39] See Guidance, § 74.

(*e.g.*, to punish customers that deal with competitors or that do not accept tying arrangements or to prevent parallel trade or maintain resale prices).[40]

The concept of refusal to supply includes refusals to supply goods or services, to license intellectual property rights, or to grant access to an essential facility or network.[41] DG Competition will treat these practices as an enforcement priority only if the following cumulative conditions are present: the product or service is objectively necessary for the buyer to compete effectively on a downstream market; the refusal is likely to lead to the elimination of effective competition in the downstream market; and the refusal is likely to lead to consumer harm.[42]

a. <u>Objective Necessity</u>

An input will be considered objectively necessary where there is no actual or potential substitute on which competitors in the downstream market could rely so as to counter – at least in the long term – the effect of the refusal. DG Competition will assess whether competitors could effectively duplicate the input in the foreseeable future.

The Guidance does not distinguish in principle between *de novo* refusals to supply and interruptions of existing supply relationships. However, if the dominant company was previously supplying the buyer, and the buyer made relationship-specific investments to use the subsequently refused input, DG Competition may be more likely to regard the input as indispensable. Similarly, if the dominant company has previously found supplying the buyer to be in its interest, it may be easier to conclude that supplying the input does not imply any risk that the owner will receive inadequate compensation for its original investment. It would therefore be up to the dominant company to demonstrate how circumstances have changed.

Where a dominant company does not refuse to supply an input but charges a price that, compared to the price it charges on the downstream market, does not allow an equally efficient competitor to compete profitably on a lasting basis, this is called a "margin squeeze". DG Competition will generally use the LRAIC of the downstream division of the integrated dominant company as the benchmark to determine whether the alleged margin squeeze would foreclose competition by an equally efficient competitor.[43]

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[40] See Guidance, §§ 75-76.

[41] See Guidance, § 77.

[42] See Guidance, § 80.

[43] See Guidance, §§ 82-83.

b. ***Elimination of Effective Competition***

The likelihood of effective competition in the downstream market being eliminated is generally greater (i) the higher the dominant company's market share; (ii) the less capacity constrained the dominant company is relative to competitors; (iii) the closer the substitutability between the products of the dominant company and its downstream competitors; (iii) the greater the proportion of downstream competitors that are affected; and (iv) the more likely it is that demand that could be served by foreclosed competitors would be diverted to the dominant company.[44]

c. ***Consumer Harm***

DG Competition will normally pursue a refusal to supply case only where the likely negative consequences outweigh over time the negative consequences of imposing an obligation to supply. Consumer harm may arise where the foreclosed competitors are prevented from bringing to market innovative goods or services and/or where follow-on innovation is likely to be stifled. This may be the case in particular where the foreclosed competitor does not intend to limit itself to duplicating the goods or services offered by the dominant company, but intends to produce new or improved goods or services for which there is a potential consumer demand or is likely to contribute to technical development. Consumer harm may also result where the price in the upstream input market is regulated, the price in the downstream market is not regulated and the dominant company, by excluding downstream competitors, is able to extract more profits in the unregulated downstream market than it would otherwise do.[45]

d. ***Efficiencies***

The Guidance recognizes a number of arguments that might support an efficiency defense in a refusal to supply case:[46]

- The need to allow the dominant company to realize an adequate return on its investments;

- The risk that the dominant company's incentives to innovate would be negatively affected by an obligation to supply; or

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44 See Guidance, § 84.

45 See Guidance, §§ 85-87.

46 See Guidance, §§ 88-89.

- The structural changes that imposing such an obligation would bring about, including follow-on innovation by competitors.

As noted, however, the fact that the dominant company has previously supplied the input in question can be relevant to any efficiency defense of the refusal to supply.

e. ***Comments***

Although the Guidance does not significantly deviate from the existing case law on refusals to supply, the tone of this part of the Guidance suggests that DG Competition will exercise particular restraint in pursuing refusal to supply and margin squeeze cases. The Guidance's focus on refusals to supply by vertically integrated dominant companies may suggest that refusals to supply by non-vertically integrated companies will not normally be considered to violate Article 82 EC. DG Competition's recognition that, before bringing a refusal to supply case, it needs to satisfy itself that the refusal is likely to eliminate effective competition and to weigh the likely consumer harm from the refusal against the harm to the dominant company of imposing an obligation to supply – factors that in the context of a efficiency defense must be demonstrated by the dominant company – is particularly welcome.

III. CONCLUSION

The Guidance represents a welcome, if overdue, effort by DG Competition to provide guidance on the application of Article 82 EC to exclusionary conduct. The Guidance is more limited than originally anticipated, in that it does not cover exploitative abuses and avoids other areas in which Commission guidance would be welcome, such as exclusionary conduct by collectively dominant companies. However, the Guidance's silence on certain conduct – such as unconditional rebates – appears to suggest that DG Competition regards such conduct as not susceptible to violating Article 82 EC.

DG Competition is to be commended for its effort to put its Article 82 EC enforcement policies on a sounder economics-based footing. Unfortunately, however, its equally efficient competitor test will be difficult if not impossible for companies and counsel to apply in determining whether proposed conduct might be found to violate Article 82 EC. The Guidance is clearer and more concise than the Discussion Paper, although to some extent concision has been achieved by eliminating examples that would have helped to clarify how DG Competition intends to apply its analytical framework.

Beyond noting the obvious fact that the Guidance is subject to the case law of the Community Courts, DG Competition does not indicate where the approach to exclusionary abuses outlined in the Guidance differs from the past practice of the Commission and the Community Courts. As in respect of other practices addressed in

the Guidance, it will be interesting to see which Article 82 EC cases DG Competition pursues going forward, and on what analytical and methodological basis.

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For additional information, please do not hesitate to contact Stephan Barthelmess, Brian Byrne, Christopher Cook, Maurits Dolmans, Francisco-Enrique González-Diaz, Nicholas Levy, James Modrall, Till Müller-Ibold, Robbert Snelders, Romano Subiotto, John Temple Lang, Dirk Vandermeersch, or Antoine Winckler of the Firm's Brussels office (+32 2 287 2000); Mario Siragusa or Giuseppe Scassellati-Sforzolini in Rome (+39 06 69 52 21); Dirk Schroeder or Romina Polley in Cologne (+49 221 800 400); François Brunet in Paris (+33 1 40 74 68 00); or Shaun Goodman in London (+44 20 7614 2200).

CLEARY GOTTLIEB STEEN & HAMILTON LLP

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax