INTERTIC

International Think-tank on Innovation and Competition

The EU Approach to Abuse of Dominance

by Federico Etro*

U.C.S.C., Department of Economics,

ECG and Intertic

Milan, February 2006

The main provisions of European Competition Law (what in US terminology would be Antitrust Law) concerning abuse of dominance are contained in the Article 82 of the Treaty of the European Communities which states:

> "*Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in: (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; (b) limiting production, markets or technical development to the prejudice of consumers; (c) applying dissimilar*

---

* This paper was written while I was economist for the Task Force on Competition of the International Chamber of Commerce. I am grateful to Jacques Bourgeois, Jean-Yves Art and Jean-Michel Coumes for important suggestions and for sharing some of their views and statements, and to Kresimir Zigic, Yannis Kotsoulakos and Massimo Motta for interesting discussion on the subject. The responsibility for the views expressed in this paper is only mine and in particular these views are not necessarily shared by the International Chamber of Commerce.

conditions to equivalent transactions with other trading parties, thereby placing them at competitive disadvantage; (d) making the conclusion of contracts subject to acceptance by other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts."

This article (as Article 81 on horizontal and vertical agreements) is part of the law of each member state and is enforced by the European Commission (in particular the Directorate General for Competition) and by all the National Competition Authorities.[1]

The application of EU competition law on abuse of dominance involves the finding of a dominance position and of an abusive behaviour of the dominant firm, usually associated with excessive pricing or with exclusionary practices as predatory pricing, rebates, tying or bundling, exclusive dealing or refusal to supply. However, the analysis of both dominance and abusive behaviours entail complex economic considerations and has been subject to a recent revision. The European Commission published, in December 2005, a Discussion Paper[2] on exclusionary abuses under Article 82 (hence on, the Discussion Paper) which is the subject of an open debate and gives an important indication as to how the Commission may approach exclusionary abuses in the future. The Discussion Paper states that the purpose of Article 82 is "the protection of competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources" (# 4).[3] This implies that antitrust should protect competition and not competitors and be based on an economic approach aiming at the maximization of consumer welfare and allocative efficiency rather than based on a legalistic approach.

In the current proposal of the guidelines for EU antitrust there are some positive aspects, mainly in the central concern to enhance consumer welfare and to protect competition and not competitors, but such a welfare-based approach is not enough supported in the overall design of these guidelines.

In what follows, we will review the EU approach to competition law regarding abuse of dominance in the general terms concerning the definition of dominance and the objectives of antitrust, and with references to the main cases of abusive conduct, and I will provide an evaluation of the Discussion Paper.

---

[1] At the EU level, the Court of First Instance has jurisdiction in all actions brought against the decisions of the Commission, while the European Court of Justice decides on appeal actions brought against the judgments of the Court of First Instance.

[2] *DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses*, Bruxelles, December 19, 2005.

[3] The Discussion Paper only deals with exclusionary abuses under Article 82 EC. It does not deal with exploitative abuses and discriminatory practices.

1. Market definition and dominance

According to the European Competition Law, dominance in a market or its creation cannot be punished, while only its abuse by dominant firms is subject to antitrust screening. Hence, the preliminary phase of any antitrust case applying Article 82 must define the relevant market and verify the existence of a dominant position. The Discussion Paper briefly refers to the definition of a proper market, which can be more complex in Article 82 cases because the market price could be above its competitive level (#11-19). This creates problems with the usual methods of market definition. For instance the *SSNIP-test*, which defines the relevant separate market as the smallest market where a Small but Significant Non-transitory Increase in (competitive) Prices (say of 5-10%) increases the profits of a hypothetical monopolist, is biased when the market is characterized by higher than competitive prices (which is more likely in cases of abuse of dominance): such a bias usually leads to a too-wide market definition, which in turn may lead to a finding of no dominance, the so-caled "*cellophane fallacy*" (from the du Pont case).

It should be noticed that the cellophane fallacy only applies in presence of a single monopolist in the market and when entry is impossible, while the SSNIP-test at the prevailing prices remains a valid test whenever the market leader is constrained by effective competition and/or potential entry.

Following a traditional definition,[4] the Discussion Paper associates dominance with "a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers" (# 20). Such a definition requires "a leading position on that market" compared to the rivals (# 22) and the lack of "effective competitive constraints" (# 23) in the process in which "the undertaking and the other players act and inter-act on the market"(# 23).

Given the positive stress put on an economic-based approach to competition policy, it is important to notice that this definition of dominance is clearly associated with two situations examined by economic analysis: the pure monopoly, as an extreme case of dominance, and the market leadership where the dominant firm faces some competitors, which is clearly the most interesting case. It should be emphasized that, according to standard economic analysis, a market leader can really act independently of its rivals (so as to satisfy the above condition for dominance)[5] only when the number of competitors is exogenously set and further entry is impossible, while a market leadership constrained by effective competition and potential entry cannot be associated with dominance: in this case, the modern theory of market leaders tells us that leaders tend to be aggressive (pro-competitive) in their

---

[4] Case 85/76 *Hoffmann-La Roche*, ECR 461, 34-5, 118n27, 499 n122.

[5] And potentially it can implement anticompetitive strategies, that is engage in abusive conduct.

pricing and investment strategies, conquering larger market shares in a way that has nothing to do with dominance as defined above, and which is also beneficial to consumers.[6]

As a consequence of the approach of the Discussion Paper, it would be better to eliminate a certain ambiguity in the statement at # 27 saying that "the fact that an undertaking is compelled by the pressure of its competitors' price reductions to lower its own prices is in general incompatible with […] the existence of substantial market power" and hence with dominance. In particular this should be always true and not just "in general", since in this case the market leader is constrained by effective competition and cannot act independently from it, as the definition of dominance would require and should be extended to any other form of aggressive competition, that is not only competition in prices, but also competition in quantities or in alternative forms of strategic investments. Hence, the fact that an undertaking is compelled by the pressure of its competitors' aggressive strategies to adopt aggressive (pricing and investment) strategies should be always incompatible with dominance.

The stress on market shares in the evaluation of dominance (# 29- 33) appears in clear contrast with the conclusions of the modern theory of market leadership: market leaders have larger market shares exactly when they are constrained by effective and potential competition since in this case they adopt more aggressive (pricing and investment) strategies which expand their market shares. In other words there is not necessarily a positive correlation between the presence of larger market shares and a dominant position and, especially in highly dynamic markets, there is not unambiguous theoretical support for a statement saying that "[m]arket share is only a proxy for market power" (# 32). As a recent DG Competition's study on Article 82[7] has correctly pointed out, "the case law tradition of having separate assessments of dominance and of abusiveness of behavior simplifies procedures, but this simplification involves a loss of precision in the implementation of the legal norm. The structural indicators which traditionally serve as proxies for 'dominance' provide an appropriate measure of power in some markets, but not in others", as indeed in high-tech and New Economy industries (as computer hardware and software, online businesses, mobile telephony and biotechnology).

Finally, the part on dominance clearly refers to competition *in* the market, while it is hardly useful to evaluate cases where competition *for* the market takes place. In these cases, typical of the New

---

[6] See Franco Modigliani (1958, "New Developments on the Oligopoly Front", *Journal of Political Economy*, 66, 3, June, pp. 215-32) and Federico Etro (2006, "Aggressive Leaders", *Rand Journal of Economics*, Vol. 37, Spring, pp. 1-10; 2006, "Competition Policy: Toward a New Approach", *European Competition Journal*, Vol. 2, March, pp. 21-47). This theory is strictly related with the pathbreaking work on contestable markets by William Baumol, John Panzar and Robert Willig, *Contestable Markets and the Theory of Industry Structure*, New York: Harcourt Brace Jovanovich, 1982.

[7] Patrick Rey (Coordinator), *Report by the EAGCP 'An Economic Approach to Article 82'",* July, 2005.

Economy, competition is dynamic and innovators conquer large parts of a market, so that any static analysis of market shares cannot say anything about dominance. In other words, a market can be currently dominated by a single firm, but if many other firms which are not even active in this market are investing in R&D to enter into it, as it happens in many high-tech sectors, this market is substantially competitive in a dynamic sense. Nevertheless, any leader in such a competitive winner-takes-all market would be always characterized as dominant by the static and market-share-based approach of the Discussion Paper.

Moreover, modern economic theory tells us that in these dynamic sectors market leaders, as long as they are constrained by effective competition in the market for innovations, invest more than their competitors and hence are more likely to remain leaders.[8] In this sense, statements saying that "high market shares, which have been held for some time, indicate a dominant position" can be true in some sectors, but not in high-tech sectors with competition *for* the market. In conclusion, the general impression is that there is an excessive stress on the importance of market shares to evaluate dominance, and that this can be highly misleading especially for dynamic markets.

The part on barriers to expansion and entry (# 34-40) concerns a concept which is far from unambiguous in economic theory. The definition of these barriers as "factors that make entry impossible or unprofitable while permitting established undertakings to charge prices above the competitive level" (# 38) applies well to legal barriers but not to other factors which are sometimes seen as barriers. For instance, high fixed costs of production and R&D or investments needed to develop network externalities or learning by doing advantages, do not make entry impossible: the correct definition in these cases would be that these factors endogenously limit entry or endogenously determine how many and which firms profitably enter. The difference is not just in the definition but also in the economic consequence, since modern economic theory has shown that when entry is impossible market leaders may behave in an anti-competitive way, but when entry is constrained by technological or demand conditions they (always) behave in a pro-competitive way even if the cited factors limit entry and the market leaders obtain high market shares.

2. The principles of EU antitrust

Despite the Discussion Paper claims that "the purpose of Article 82 is not to protect competitors from dominant firms' genuine competition based on factors such as higher quality, novel products, opportune innovation or otherwise better performance, but to ensure that these competitors

[8] See Etro (2004, "Innovation by Leaders", *Economic Journal*, Vol. 114, 495, April, pp. 281-310).

are also able to expand in or enter the market and compete therein on the merits, without facing conditions which are distorted or impaired by the dominant firm." (# 54), these principles are not fully carried through into certain aspects of the analytic framework. In particular, it would be better to stress more that the interests of consumers are always paramount of those of competitors, to move even further away from form-based rules and presumptions towards a more economics- and fact-based approach, and to expand the avenues through which account may be taken of the efficiency-enhancing effects of challenged conduct. The analysis of whether a firm has engaged in abusive conduct under Article 82 should ultimately turn on the conduct's actual effects on efficiency and consumer welfare. Thus, if the pro-consumer benefits of a dominant undertaking's conduct are significant, it should be immune from liability even if it disadvantages certain competitors: inventing better products or more efficient methods of distribution, reducing prices or offering better terms of trade, and more quickly adapting to changes in the market can disadvantage rivals and maybe even cause them to exit the market, but these forms of conduct often also enhance efficiency and consumer welfare.[9]

In spelling out the concept of foreclosure, the Discussion Paper states that "it is sufficient that the rivals are disadvantaged and consequently led to compete less aggressively" (# 58). This proposition gives cause for concern. First, this statement is not consistent with standard economic theory which has made clear that an aggressive behaviour of the market leader inducing a less aggressive competition of its competitors is not sufficient to create any harm to consumers (actually the net effect is typically the opposite happens).[10] The inconsistency of this statement is even more clear when it is claimed that

---

[9] This focus is particularly important with respect to fast-moving markets such as those commonly found in high-tech and New Economy industries. These industries are often characterised by massive R&D investments, strong reliance on IPRs and other intangible assets, network effects, high fixed sunk costs and low marginal costs. Competition in these markets is dynamic in the sense that competition often takes place for the market in a "winner-takes-all" race. Leading firms in these markets might enjoy high market shares yet be subject to massive competitive pressure to constantly create better products at lower prices due to threats from innovative competitors and potential entrants. Companies that hold a significant share of the market at any given point of time may see this share decrease rapidly and significantly following the development and supply of a new and more attractive product by an actual or potential competitor. The launch of the iPod by Apple and its impact on the distribution of so-called "MP3 players" (small and light devices used for storing and playing digital music files) is a good example of such rapid and drastic market developments.

[10] As pointed out by well established economic doctrine (Drew Fundenberg. and Jean Tirole, 1985, "The Fat Cat Effect, the Puppy Dog Ploy and the Lean and Hungry Look", *American Economic Review*, 74 , May, pp. 361-68), an aggressive behaviour of the market leader can lead to more aggressive competition by a competitor (generally under competition in prices) or to a less aggressive one (typically under competition in quantities) with positive consequences for the consumers in the first case and only ambiguous ones in the second (see Williamson, O. E., *The Economic Institutions of Capitalism* (New York, Free Press, 1985) for an early evaluation of this approach).

"[r]ivals may be disadvantaged where the dominant company is able to … reduce demand for the rivals' products" (# 58) which is really what any aggressive or pro-competitive strategy would do. Putting together the two sentences, we are told that it would be sufficient to establish foreclosure that the strategy of the dominant firm reduces demand for the rivals' product: but this amounts to banish any pro-competitive strategy by market leaders. Moreover, the above statement could arguably support the conclusion that a dominant company in a market characterized by network effects could be guilty of abuse if it is able to attract new customers on the basis of a new, superior technology. This view is contrary to the basic principle that dominant companies should be permitted (and indeed encouraged) to compete aggressively on the merits. Allowing a finding of abuse merely where competitors are "disadvantaged" would penalise dominant firms for engaging in a wide range of conduct that is ultimately pro-competitive. In our view, this aspect of the analytic framework should be revised to clarify that conduct by a dominant firm would be deemed to be an abuse only if its net effect is to harm consumer welfare.[11]

The Discussion Paper states that the Commission may at times prohibit the use of price discounts where doing so will "protect competitors that are not (yet) as efficient as the dominant company" (# 67). In our view, there is no economic justification for barring dominant firms from decreasing prices simply in order to protect less efficient rivals (particularly since such a prohibition will mean that these rivals will face even *less* competitive pressure to become more efficient). This condition also places dominant firms in the untenable position of having to guess what level of rival inefficiency will be used to judge whether the dominant firm's own efficiency-enhancing conduct is lawful. The Discussion Paper also states, in its discussion of the meeting competition defense, that a dominant firm has an obligation to weigh "the interests of its competitors to enter or expand" into the market when deciding upon alternative courses of action, and that dominant firms can only benefit from this defence if they prove there was no less anticompetitive alternative (# 82-83). In the real world, the best businesses are focused on advancing the interests of their customers, not their competitors (which, of course, is one sign of a competitive market). Thus, most dominant firms will be ill-equipped to evaluate which of various possible options will least disadvantage their competitors. We

---

Moreover, when entry of competitors is endogenously taken into account (which should be the relevant case), an aggressive behaviour of the leader does not affect each single competitor but can reduce entry, with net effects for consumer welfare and allocation of resources which are always positive (Etro, 2006). Hence, an aggressive behaviour of the market leader inducing less aggressive competition of the competitors is not sufficient to create any harm to consumers or to deteriorate the allocation of resources.

[11] *See, e.g.*, Commissioner Neelie Kroes, *Preliminary Thoughts on Policy Review of Article 82*, at 3 (23 Sept. 2005) (stating that, in the analysis of exclusionary conduct under Article 82, "ultimately the aim is to avoid consumers harm").

would therefore recommend that this requirement that dominant firms weigh the interests of competitors be dropped from the analysis.

EU Competition Law has been criticised for focusing more on the form of unilateral conduct than on its actual effects in the marketplace. There is broad consensus among economists that (unilateral) price- and non-price conduct of dominant firms may produce both pro- and anticompetitive effects. The ambiguous nature of conduct of dominant firms militates in favour of a full appreciation of the (positive and negative) effects on consumers. It is therefore vital that the framework for analysis under Article 82 provides for a rigorous, economics-based examination of the market context in which unilateral conduct occurs. For instance, the Commission should clarify that, despite the references to the "form and nature" of conduct in the general discussion of exclusionary abuses (# 58-59), whether market foreclosure will be found to exist will ultimately turn on the actual effects of the conduct in the marketplace. Also, while we commend the Commission for placing less reliance on *per se* rules and irrebutable presumptions of market foreclosure and abuse, the Discussion Paper retains elements of this approach. For example, in several places, certain forms of conduct or market shares will make it "highly unlikely" that some legal determination will result (# 30, 90, 91). We would urge the Commission to lessen its reliance even on these quasi-*per se* rules and to adopt a more thoroughgoing, economics- and effects-based analysis that focuses on increasing consumer welfare and is based on sound economic theory of the behaviour of market leaders and on solid empirical analysis.[12] The recent DG Competition's study on Article 82 (Rey et al., *Report by the EAGCP 'An Economic Approach to Article*

---

[12] Furthermore, we are not persuaded that an approach based on the weighing of pro- and anti-competitive effects will decrease legal certainty. Much of the current uncertainty about the boundaries between permissible and prohibited business practices results from a form-based approach to certain pricing practices and the difficulty inherent in such an approach in determining whether new kinds of economic activity should be regarded as being of one type of form or another. Form-based approaches lack consistent and rigorous analysis of the concrete effects of a given practice and often have the effect of condemning profit-maximizing conduct that benefits consumers. The uncertainty that results from the condemnation of conduct that may not have any significant impact on competition or that may benefit consumers creates added risks for business, which itself reduces efficiency, and deters undertakings from applying business practices (e.g. certain pricing schemes) which in fact increase competition and are beneficial for consumers.The recent DG Competition's study on Article 82 (Rey et al., *Report by the EAGCP 'An Economic Approach to Article 82,'"* July 2005) correctly emphasizes the need of solid theoretical and empirical foundations in the antitrust procedure: "a natural process would consist of asking the competition authority to first identify a consistent story of competitive harm, identifying the economic theory or theories on which the story is based, as well as the facts which support the theory as opposed to competing theories. Next, the firm should have the opportunity to present its defense, presumably to provide a counter-story indicating that the practice in question is not anticompetitive, but is in fact a legitimate, perhaps even pro-competitive business practice."

82,'" July 2005) correctly emphasizes the need of solid theoretical and empirical foundations in the antitrust procedure: "a natural process would consist of asking the competition authority to first identify a consistent story of competitive harm, identifying the economic theory or theories on which the story is based, as well as the facts which support the theory as opposed to competing theories. Next, the firm should have the opportunity to present its defense, presumably to provide a counter-story indicating that the practice in question is not anticompetitive, but is in fact a legitimate, perhaps even pro-competitive business practice."

Conduct that generates efficiencies should not, in our view, be deemed abusive unless it is demonstrated that the impact of this conduct on competition will result in consumer harm outweighing these efficiencies. While the Discussion Paper acknowledges that promoting efficiency is one of the primary objectives of Article 82, the framework for analysis itself actually provides relatively limited scope for taking efficiencies into account. This manifests itself in a variety of ways:

First, the Discussion Paper indicates that, consistent with existing practice, it will fall on dominant firms to prove the extent to which their conduct was justified on grounds of efficiency (# 77, 79). Bringing efficiencies into the analysis only as an affirmative defense will send the wrong signal to the business community: it means that investigations will often have moved quite far along before efficiency considerations fully come into play. Placing the burden of proof on competition authorities, by contrast, makes more sense as they are likely to be in a better position to obtain relevant evidence from the dominant firm as well as other market participants (such as consumer organizations) on whether challenged conduct promotes efficiency—and have the expertise and resources to undertake such an inquiry. Accordingly, we believe it is for the authority investigating an alleged infringement of Article 82 to support any finding of abuse by evidence that the conduct at issue is not justified by efficiencies, in particular in those instances where the dominant company proposes a prima facie efficiency justification.

Second, according to the Discussion Paper, to assert a successful efficiency defense under the proposed analytic framework, dominant firms will be required to show that their conduct was "indispensable" in order to achieve the resulting efficiencies and that "competition in respect of a substantial portion of the products concerned [was] not eliminated" (# 84). To meet the first of these conditions, the defendant must "demonstrate that there are no other economically practicable and less anticompetitive alternatives to achieve the claimed efficiencies" (# 86). This condition means that liability could be imposed even on conduct whose efficiency and consumer benefits far outweigh its adverse effect on competitors simply because there exists an alternative that would have disadvantaged rivals less. In our view, this rule has no economic justification: at most, it will merely provide an excuse for rivals to second-guess the business decisions of their dominant competitors. The latter condition implies that efficiency claims by dominant firms, particularly those with high market shares, will

systematically be given short shrift because of the difficulty of satisfying this condition: in essence, dominant firms effectively will be required to place the interests of competitors and the competitive process over the interests of efficiency and consumer welfare.

Finally, the Discussion Paper also seems to suggest that, where a dominant firm holds a market share above 75 percent, the protection of competitors will be given priority over efficiency. In our view, efficiencies should be assessed in the same manner in all cases, regardless of the defendant's market share. Under the Treaty, and consistent with the goals of Article 82 as articulated by Commissioner Kroes, firms that generate pro-competitive efficiencies that benefit consumers should not be penalised regardless of the level of market share or potential impact on less efficient competitors. Moreover, the Discussion Paper introduces a concept of market position "approaching that of a monopoly" (# 92), for market shares above 75%, which has not any foundation in economic analysis. And the same economic analysis does not justify any separate treatment for firms with high market shares. Moreover, as emphasized by the modern economic theory, market leaders tend to have higher market shares exactly when they face an effective competitive pressure which induces them to adopt aggressive (pricing and investment) strategies and hence to expand their market shares in a pro-competitive way[13]: under these conditions, exceptionally high market shares (but not monopolistic ones) can be due to relevant scale economies or to the existence of learning by doing or network effects, but they do not justify exclusion from efficiency defence.

3. Predatory Pricing

Predatory pricing is defined in the Discussion Paper as "the practice where a dominant company lowers its prices and thereby deliberately incurs losses or foregoes profits in the short run so as to eliminate or discipline one or more rivals or to prevent entry by one or more potential rivals thereby hindering the maintenance or the degree of competition still existing in the market or the growth of that competition" (# 93). The Discussion Paper uses a number of cost benchmarks in order to assess whether "predatory pricing" by a dominant company has actually taken place.

Pricing below average avoidable cost ("AAC") gives rise to a rebuttable presumption that the pricing is "predatory". Average avoidable cost is the average of the costs that could have been avoided if the company had not produced a discrete amount of extra output (this extra output is usually the amount allegedly subject to abusive conduct). In theory, this principle is supported by the idea that pricing below marginal cost could only have a predatory purpose, but the concept of marginal cost is difficult to

[13] See the discussion on Dominance above.

measure. This is in line with the standard antitrust doctrine since Areeda and Turner (1974) [14] noticed that "the incremental cost of making and selling the last unit cannot readily be inferred from conventional business accounts, which typically go no further than showing observed average variable cost. Consequently it may well be necessary to use the latter as an indicator of marginal cost". However, the Discussion Paper substitutes the *Areeda-Turner test* based on AVC with the AAC, a sort of average marginal (or incremental) cost of the extra output to serve the predatory sales. Unfortunately, the AAC can be quite higher than the right theoretical concept whenever it accounts for fixed costs. Moreover the AAC can be much more difficult to measure than the AVC since it is almost always impossible to precisely define which costs are sustained for a given output and isolate the extra output (supposedly the predatory output) from total output. Finally, there are well known conditions, as in presence of network externalities, under which pricing below marginal cost is a normal competitive strategy for a market leader. Hence it would be better to substitute the concept of AAC with that of average variable cost (AVC), in line with the traditional economic interpretations of the Areeda-Turner test.

According to the Discussion Paper, where pricing is above AAC, but below average total cost ("ATC"), the Commission will need to show, on the basis of objective factors, that the dominant company's pricing has a "predatory intent" (i.e. predation cannot be presumed). ATC is the average of the variable and fixed costs incurred by a company. Pricing above ATC is in general not considered predatory, but according to the virtually unanimous economic literature, it would be better to state that pricing above ATC is never predatory since it cannot lead to foreclosure of 'as efficient' competitors.

In certain sectors, the Commission uses a long-run average incremental cost benchmark ("LAIC"), instead of AAC. This is usually the case in industries where fixed costs are high and variable costs very low. In these cases, the LAIC benchmark is used as the benchmark below which predation is presumed. Pricing above LAIC but below ATC in these sectors is assessed in the same way as pricing above AAC but below ATC in all other sectors (i.e. the Commission will need to prove a "predatory intent"). We believe that the long-run incremental costs standard is inconsistent with business reality because it requires companies to price to cover average long-run variable costs, which includes sunk fixed costs that are unrecoverable. This approach ignores the economic reality that, when businesses decide how to price a product, they do not consider costs that are "sunk" or "unrecoverable," even if not a single product is sold. Indeed, if they were to consider such sunk costs in their pricing decisions they would engage in the so-called "sunk cost fallacy", which is when a business person makes decisions based on the fallacy that money already irreversibly spent on a project might be "unspent" or recovered if the project is abandoned. The Discussion Paper's reliance on long-run incremental costs to measure foreclosure is based on the assumptions that an automobile factory can be converted into a

[14] See Phillip Areeda and Donald Turner (1975, "Predatory Pricing and Related Practices under Section 2 of the Sherman Act", *Harvard Law Review*, 88, pp. 637-733) and, for an economic commentary, William Baumol (1996, "Predation and the Logic of the Average Variable Cost Test", *Journal of Law & Economics*, 39, April, pp. 49-72).

semiconductor plant and that a steel worker can be retrained to become a software engineer without cost. These assumptions do not reflect economic reality.

Under the Discussion Paper, a dominant company may, even if the price is below the relevant cost benchmark, rebut a finding of predatory pricing by providing a “justification” for its pricing behaviour (this is a departure from earlier case-law, where pricing below AVC was considered to be abusive *per se*). The Discussion Paper lists several examples of possible justifications (# 131), including an issue of re-start up costs or strong learning effects, the need to sell off perishable or obsolete stock and the justification that the low price is a short-run loss minimising response to changing conditions in the market (including those resulting from a dramatic fall in demand leading to excess capacity). It is surprising that besides learning effects, the Discussion Paper does not cite network effects, whose theoretical role in justifying aggressive pricing is very similar to that of learning by doing.

4. Rebates and Single Branding

The Discussion Paper states that “as efficient” competitors can be foreclosed from the market by conditional rebates applied by a dominant supplier in particular if the five following cumulative conditions are met:

(i) the rebates apply to all purchases (including past purchases) made within the reference period, that is they are retroactive;

(ii) the threshold is set at a level that induces switching customers to buy additional quantities from the dominant company;

(iii) competitors’ required share exceeds the commercially viable amount per customer (as calculated by the Commission on the basis of the dominant company’s ATC and the effective price of the last slice of the rebate). If the basic price of the dominant firm is p, the percentage rebate is r, total sales are $S+X$, of which S is the threshold above which rebates start and X are the extra sales beyond the threshold, then the effective price for the same extra fraction of sales is given by the difference between total price with the rebate $p(1-r)(S+X)$ and the total price of the threshold quantity without rebates pS, divided by the extra quantity X:

$$EP = \frac{p(1-r)(S+X) - pS}{X} = p\left(1 - \frac{r(S+X)}{X}\right) = p\left(1 - \frac{r}{x}\right)$$

where we defined $x=X/(S+X)$ the fraction of extra sales. When this average price is below the average total cost ATC entry is foreclosed. Assuming that ATC is constant and equal to c, the necessary condition can be derived. A competitor with the same

average total cost of the dominant firm could profitably enter only selling at least the fraction:

$$\hat{x} = \frac{pr}{p-c}$$

which is defined as the required share.

(iv) the rebate system ties a significant part of buyers; and

(v) there is no clear indications of significant entry or customers' switching.

Factors under (i), (ii) and (iii) seem highly unreliable for multiple reasons. First, the rebates under discussion are substantially equivalent to a pricing strategy with thre brackets. Indeed, total price as a function of total sales T is pT for $T<(1-r)S$ and $pT(1-r)$ for $T>S$, while it is constant at pS for intermediate values of sales between $(1-r)S$ and S (since for these amounts of sales it is always better to buy S and exploit the rebate). This implies that the pricing system is very similar to a simple quantity discount, which as well known has a welfare enhancing role. [15] The implication is that similar rebates should never be considered abusive when the percentage rebate is small enough since they have similar effects to simple quantity discounts.

Second, any kind of fidelity rebate can have a pro-competitive role in the sense that it creates a further dimension of competition (the non-linear price schedule) and it can represent a more aggressive pricing strategy: hence an additional minimal condition for rebates to be abusive should be that competitors are not able to propose similar rebates or different ones (with different thresholds), but this issue is absent from the list of conditions.

Third, the theoretical formulation of point (iii) is largely unrelated or inconsistent with standard economic theory and it is affected by a dangerous theoretical problem. The derivation of the formula for the required share is valid assuming that the ATC is constant. However, in general the average total cost is not constant and typically U-shaped, so that firms producing different amounts have different ATCs and there is usually a minimum ATC associated with a certain scale of production. Now, suppose that ATC depends on the fraction of sales x according to a general relation $AC(x)$ – the particular case where this is constant is assumed by the Discussion Paper. Now, according to the reasoning of the Discussion Paper, foreclosure would require:

$$EP = p\left(1-\frac{r}{x}\right) < AC(x)$$

In general, this is not equivalent to a cut-off rule for which the competitors' required share exceeds the commercially viable amount per customer. For instance, if we are in the range for which

[15] For instance see Massimo Motta, *Competition Policy. Theory and Practice*, Cambridge: Cambridge University Press, 2004 (Chapter 7).

ATC is increasing (which is likely to be the relevant one if we are referring to a dominant firm with a large market share), we actually have the opposite result.[16] In general, applying mechanically the cut-off rule suggested in the Discussion Paper is theoretically inconsistent and can lead to completely ineffective conclusions whenever the market is characterized by a minimum efficient scale.[17]

Fourth, this calculation method is far too complex to be applied by business people in their daily practice. When negotiating rebates with customers, one may wonder how dominant companies could reasonably project whether or not the last slice of the rebate will exceed their ATC at the particular point in time when the customer precisely buys the last slice. In most cases, dominant companies will not be able to determine whether their ATC is below the effective price because they will lack information on their competitors' 'commercially viable shares/ required shares'. Moreover, the calculation method also opens the door to legal uncertainty since it is extremely difficult to calculate CVT with accuracy.[18]

If a dominant company grants rebates on incremental purchases only (in other words, if the rebate is not "retroactive" because it only applies to purchases above a target or threshold), the Commission may conclude that the rebate system constitutes an abuse only if the resulting price for these incremental purchases is a "predatory price". We would welcome some specific examples or guidance showing in practice how this type of rebates is likely to have foreclosure effect. The wording of the Discussion Paper is vague and gives the Commission significant flexibility in its assessment. It should be kept in mind that conditional rebates on incremental purchases are exactly equivalent to quantity discounts whose welfare enhancing role is well known in economic theory.

The rebates described above can be classified as "conditional rebates" since they are dependent on the purchasing behaviour of buyers (i.e. buyers will qualify for a rebate if they purchase a certain quantity from the dominant company). Unconditional rebates, in contrast, do not take the purchasing behaviour of buyers into account. They may, in exceptional cases, have exclusionary effects. For instance, they may have exclusionary effects if the rebate is granted only to buyers that might more easily switch to competing suppliers (e.g. if they are granted only to buyers located in a border region to

---

[16] Formally if $AC(x)$ is U-shaped, the relation holds for required shares within a closed set and not above a threshold. Hence a mechanic application of the formula may lead to derive the upper bound of the set rather than its lower bound, leading to completely wrong conclusions in every case!

[17] Or whenever the market is not a natural monopoly, that I in every relevant case for our purposes.

[18] There is also a risk that the selected operational test may tip the burden of proof quite heavily against the dominant company. Under the 'new approach', presumed abusive and foreclosure effects will be mathematically calculated by the Commission on the basis of an equation, the main parameters of which (required share, commercially viable share and sometimes ATC) will be unknown to or difficult to establish by the dominant company, as admitted in the same Discussion Paper (# 163).

avoid that they purchase from foreign suppliers). The Commission will apply the rules developed in relation to predatory pricing to such unconditional rebates. We understands that this type of rebates is generally unproblematic except if the dominant company targets some important customers. As mentioned above, the 'importance' of customers is a dangerous and subjective concept, which should be clarified and subject to a strict interpretation. Otherwise, it will give competitors significant flexibility to argue that unconditional rebates are abusive by targeting an 'important' customer.

Rebates may provide an economic inducement for a buyer to purchase all or a significant part of its requirements from the dominant supplier. Single branding obligations, in contrast, are obligations which require the buyer on a particular market to concentrate its purchases "to a large extent" with one supplier by obliging the buyer to purchase all or "a significant part of its requirements" from the dominant supplier. The higher the percentage of their total requirements buyers must purchase from the dominant supplier, the stronger will be the foreclosure potential of the single branding obligation. If a single branding obligation is applied to a "good part of its buyers", and the obligation therefore affects, if not most, at least a "substantial part of market demand", the Commission is likely to conclude that the obligation will have a "market distorting foreclosure effect". The Discussion Paper states that single branding obligations may have such effects even if only a "modest part of market demand" is affected by the obligation.

In general, the short duration of a contract containing a single branding obligation, or a right to terminate such a contract on short notice, may not limit the foreclosure effects. If, for a significant percentage of buyers, there are no proper substitutes to the dominant supplier's products, buyers will not be able to forego purchasing from the dominant supplier. A short duration, or the right to terminate on short notice, may thus be illusory since buyers will, in practice, renew the contract with the dominant supplier, or opt not to terminate the supply arrangement. In such circumstances, in order avoid foreclosure effects, the dominant supplier will have to permit buyers to purchase from alternative suppliers, whilst at the same time allowing them to continue purchasing from the dominant supplier. However, a short duration, or the right to terminate on short notice, may limit foreclosure effects in markets where products are homogeneous and competitors are not capacity constrained. If the dominant company only applies the single branding obligation to a limited number of its buyers, the Commission will investigate whether or not these buyers are of particular importance for the entry or expansion of competitors.

The dominant firms can justify the use of rebates or single branding obligations using an efficiency defence. A rebate system or a single branding obligation could, for example, be indispensable to obtain cost savings, which thereafter can be passed on to consumers as lower prices. They could also be indispensable to provide an incentive for the dominant supplier to make relationship-specific investments in the buyer's business (e.g. the supplier may pay for equipment, training …). Although we

welcome the introduction of an efficiency defense in the context of Article 82EC, the examples contained in # 172-176 seem to introduce a very limited defense. As regards the first example, it is extremely difficult for dominant companies to quantify which amount of cost efficiencies is specifically linked to a specific percentage of the rebate grid. The two other examples (rebates applied to large retailers and relationship-specific-investment) refer to specific situations and offer limited guidance in practice.

5. Bundling

The Discussion Paper states that "tying" is the making of the purchase of one product or service (i.e. the "tying product") conditional upon the purchase of another product or service (i.e. the "tied product"). "Bundling" is the practice by which a company forces ("pure bundling"), or economically induces ("mixed bundling"), customers to buy a "bundle" consisting of the two distinct products. Virtually any product is a bundle since it combines multiple basic products which could be or are sold separately: a car bundles many separate components, a dinner at a restaurant bundles food and drinks of different brands, shoes usually bundle two shoes and their respective shoelaces, Coke bundles many ingredients (covered by trade secret), a computer bundles hardware, a operating system and basic softwares of general interest, Sunday issues of many newspapers bundle the basic journal with a magazine or special offers.[19]

The Chicago school has advanced efficiency rationales in favour of bundling with positive, or at worst ambiguous, consequences on welfare, including production or distribution cost savings, reduction in transaction costs for the customers, protection of intellectual property, product improvements, quality assurance and legitimate price responses. Moreover, according to the so called "single monopoly profit theorem", as long as the secondary market is competitive, a monopolist in a separate market cannot increase its profits in the former by tying the two products. Actually, in presence of complementarities, it can only gain from having competition and high sales in the secondary market to enhance demand in its monopolistic market. This point is made just stronger in presence of network effects.

The post-Chicago approach has shown that, when the bundling firm has some market power, bundles can have a predatory purpose, that is they can deter entry in the tied product market to expand monopolistic power and reduce consumer welfare at least in the long run (Whinston, 1990).[20]

---

[19] See Christian. Ahlborn, David. Evans and Jorge Padilla (2004, "The Antitrust Economics of Tying: a Farewell to per se Illegality", *The Antitrust Bulletin*, Spring-Summer, pp. 287-34) for a survey.

[20] See Michael Whinston (1990, "Tying, Foreclosure and Exclusion", *American Economic Review*, 80, pp. 837-59).

Summarizing the past economic research in the field, Tirole (2005)[21] has pointed out that the impact of tying on competition in the tied market ranges from a negligible impact on the rivals' ability to compete to entry deterrence, depending on a number of factors like "the marginal cost of manufacturing the tied product; the rivals' ability to differentiate horizontally or vertically their offering from the tied product (that is, to offer some features that are not available in the tied product); and, if the market is multi-sided, the ability to differentiate, in the side where there is no tie, through technological features, in-house supply, or exclusive contracts with third-party vendors, and the ease with which users on the tying side can multi-home." According to Tirole, and we agree on this, tying should be submitted to a rule-of-reason standard, since it can have both efficiency and anti-competitive purposes.

The theory of market leaders (Etro, 2006) emphasizes that bundling by the incumbent 1) is just an aggressive (pro-competitive) strategy of the incumbent for a competitive tied product market, 2) may not have a specific entry deterrence purpose, and 3) may increase welfare even without taking efficiency reasons into account.

To derive these results, let us adopt the strongest bias against the bundling firm, imagining that this is a monopolist in a primary market with the possibility to enter in a secondary market, and that there are no clear technological efficiencies to obtain by bundling goods in the two markets. The Chicago school has studied such a situation when the secondary market is perfectly competitive, that is firms price at marginal cost and earn no extra profits: in such a case, the monopolist has no incentives to bundle because this could only reduce demand in the primary market. The post-Chicago approach has studied the same situation when the secondary market is not perfectly competitive and there is actually one single firm active strategically and no possibility for other firms to enter: then the only reason why the monopolist would like to adopt a bundling strategy is to induce exit of the rival in the secondary market (Whinston, 1990). Finally, the new theory of market leaders has studied again the same situation but with a secondary market where firms decide "endogenously" whether to enter or not. In this case, the purpose of bundling has nothing to do with entry deterrence, it is just an aggressive strategy (but not a predatory one) which has pro-competitive effects: it reduces the combined price level and increases welfare. Technically, the market leader can exploit a larger scale of production for the bundle to offer it at a competitive price: bundling the two products works as a commitment device to be aggressive, that is to produce more for the secondary market and hence to be able to adopt a lower price. As a consequence, the leader can exploit larger scale economies, reduce the average price level for the consumers and hence increase welfare (Etro, 2006).

Summarizing, while approaching a bundling case we need to verify the entry conditions of the secondary market. If there is a dominant firm in this market as well, the main problem is not the bundling strategy, but the lack of competition in the secondary market, and it should be addressed within

[21] See Jean Tirole (2005, "The Analysis of Tying Cases: A Primer", mimeo, University of Toulouse, 2005).

this market: punishing the bundling strategy would just guarantee the monopolistic rents of the dominant firm in the secondary markets. However, things are different when the secondary market is not monopolized but open to endogenous entry (even if it is not perfectly competitive, in the sense that firms do not price at marginal cost). In such a case bundling is a pro-competitive strategy and punishing it would hurt consumers. Finally, notice that we achieved these conclusions ignoring the possibility that the bundling firm could create technological efficiencies by bundling its products, excluding that this firm could have a somewhat limited market power in the primary market and even ignoring the benefits from bundling in case of complementarities between the products: taking these factors in consideration could only strengthen the results against the punishment of a bundling strategy.

Let us now go back to the European Competition Law. In order for Article 82 EC to be infringed by tying or bundling the supplier must be dominant in at least the tying market. The Discussion Paper lists three other cumulative conditions which must be met in order for such practices to be considered abusive under Article 82 EC: 1) the tying product and the tied product must be "distinct" products; 2) the practice must be likely to have a "market distorting foreclosure effect"; and 3) the practice must not be justified objectively or by efficiencies.

The Discussion Paper states that two products are "distinct" if, in the absence of tying or bundling, customers would purchase them separately (in line with the established case-law), but two products that previously were "distinct" may become one product when consumer demand has shifted as a consequence of product integration so that there is "no more independent demand for the tied product".

The Commission must, when assessing if the tying forecloses the market for the tied product, establish a) which customers are foreclosed to competitors, and b) whether these customers represent a "sufficient" part of the market. The first part of the analysis may be especially difficult to carry out in the case of "mixed bundling", which occurs when the price charged for the bundle is less than the total price for the products when sold individually. Competing suppliers may be foreclosed by "mixed bundling" if the discount granted for buying the two products together is so large that "as efficient" competitors offering only some of the products cannot compete against the bundle. If, however, the incremental price that customers pay for each of the products covers the long run incremental cost of producing each product, there will be no foreclosure of "as efficient" competitors. The quality or good usage of the products necessary to protect the health or safety of customers may, in principle, be invoked as objective justifications for tying. Alternatively, an efficiency defence can also be invoked (e.g. savings in production, distribution or transaction costs).

We welcome the Discussion Paper's recognition that tying and bundling are often pro-competitive and its movement away from the "*per se*" approach to these practices reflected in prior case law. Indeed, as discussed above, economists today generally acknowledge that tying often produces

positive efficiencies and consumer benefits. As seen above, the procompetitive effects of tying are particularly pronounced in the case of technical tying (when companies innovate by linking formerly separate technologies or products, efficiencies often emerge through improved performance and quality), but they also emerge because tying is often used as an aggressive strategy which leads to lower prices. While the Discussion Paper purports to adopt a more balanced approach that takes into account that tying and bundling can be pro-competitive, we are concerned that this approach is not carried through into the details of the analysis. A close reading suggests that certain older presumptions against tying remain embedded in the analysis, which, taken together, risk perpetuating the current situation in which tying and bundling are viewed as suspect unless proven otherwise.

We have doubts on the same definition of tying, which places too much emphasis on consumer demand for the tied product. Such demand does not shed light on whether there exist distinct products for the purposes of tying analysis, which uses the distinct products test as a proxy for determining whether the tying arrangement produces efficiencies. In other words, while there is clearly consumer demand for shoelaces, this should not mean that shoes and shoelaces are distinct products for the purposes of tying analysis. This issue can only be addressed by asking whether there is consumer demand for shoes without shoelaces. In sum, whether or not consumer demands exists for the tied product is the wrong question; the correct question is whether there is any significant consumer demand for the tying product *without* the tied product. Unless the analysis focuses on this question, there is a danger that the mere existence of consumer demand for the tied product may prevent the emergence of efficient tying arrangements and end up protecting suppliers of tied products at the expense of consumers and innovation. In the case of technical integration of two products that were previously distinct, the distinct products test itself may not be helpful for understanding market dynamics because, by definition, this test is backward-looking. A better approach in these cases would be simply to ask whether the company integrating the previously distinct products can make a plausible showing of efficiency gains: since technical tying is normally efficient, market leaders would be able to continue producing innovative products benefiting consumers without running afoul of the prohibitions on tying.

Moreover, the treatment of "commercial usage" in the context of market foreclosure does not reflect the economics of tying. According to the Discussion Paper, the sale of a tied product by a dominant company may be an abuse, even when it is standard commercial practice (# 182). Furthermore, the fact that a competitor ties may add to the foreclosure effect (# 197). This overlooks that in practice, the customary nature of bundling is evidence that such tying generates efficiencies, or that there is no demand for the unbundled product. If there were sufficient customer demand to make the supply of the unbundled product profitable, competitors of the dominant company would most likely avail themselves of this business opportunity.

While we agree with the Discussion Paper's general approach to determining when a discounted or "mixed" bundle might give rise to foreclosure, we disagree with the specific test proposed and with the LAIC standard. A more appropriate cost standard in this case would be marginal costs (MC) or at least Average Avoidable Costs (AAC). When business people decide whether or not to make a marginal sale at a particular price, they generally consider the marginal cost of making that sale. We note that the Discussion Paper uses AAC as the appropriate measure of cost in its predatory pricing guidelines and that same reasoning supports AAC as the appropriate measure of cost in the mixed bundling context. Indeed, the only time the Discussion Paper uses the long-run average incremental cost measure in the predatory pricing context is when addressing pricing by monopolies that are (or were) established by law.

We are concerned that the standard of proof the Commission is required to meet to establish harmful foreclosure effects is too low, particularly in light of the fact that the analysis of foreclosure effects can be speculative in nature. In the case of tying, actual market foreclosure effects are not required by the Discussion Paper: it is enough that such effects are "likely" to occur. In other words, the mere risk of foreclosure can result in a finding against a dominant company. A standard of proof that requires convincing evidence will help ensure that companies will not be deterred from bringing new products to market as a result of concerns about remote, potential foreclosure effects.

Finally, we are concerned about both the burden of proof placed on the dominant firm as well as the standard of proof that it must meet to establish the existence of efficiencies. Procedural rules that create presumptions against the dominant firm are particularly out of place in the case of tying and bundling practices, which are recognized to be pro-competitive in most cases. We are also concerned that the Discussion Paper fails to acknowledge that bundling can be used to create value for consumers in markets that experience network effects or in multi-sided markets. In fact, with regard to network effects, the Discussion Paper indicates that foreclosure effects of a bundle may be greater when there are network effects (# 199). In such markets, bundling is a valuable strategy to gain broader distribution of the products or service that is subject to network effects. And the broader the distribution, the greater the value produced for all consumers. This is particularly true when the product or service in question has a low (or no) marginal costs, because the supplier can costlessly include the product or service in bundles with other products. In this respect the guidelines are interpreting Art 82 to outlaw business practices that create wealth for society and large consumer benefits.

6. Vertical foreclosure

Vertical foreclosure can be anticompetitive. According to the Discussion Paper, examples include halting supplies to punish buyers for dealing with competitors and refusing to supply buyers that do not

agree to exclusive dealing or tying arrangements and abusive behaviour in aftermarkets (markets for "secondary" products, such as spare parts, consumables or servicing, which are bought after the purchase of the primary product; e.g., toner cartridges for printers, replacement parts for household appliances or maintenance for computer equipment)[22] and mainly *refusals to supply*, that is "situations where a dominant company denies a buyer access to an input in order to exclude that buyer from participating in an economic activity" (# 209). The Discussion Paper distinguishes three situations: where an existing supply relationship is terminated, where there is a refusal to commence supplying an input, including situations where this input is covered by IPRs, and where the input is information necessary for interoperability.

The Discussion Paper states that four conditions have to be fulfilled in order to find the termination of such a supply relationship to be abusive: (i) the behaviour must be properly characterised as a termination of the supply arrangement; (ii) the refusing undertaking must be dominant; (iii) the refusal must be likely to have a negative effect on competition; and (iv) the refusal must not be justified objectively or by efficiencies. There is no reference to the need to show that the input is "indispensable". This implies that the termination of an existing supply relationship is more likely to be abusive than a refusal to supply a new customer. Assuming dominance and a termination of a supply arrangement are

[22] The Discussion Paper has a short part on this subject. When an after-market is "brand-specific" (i.e. where secondary products for one brand of primary product cannot be used with another brand of primary product), the supplier may have a very large share of that after-market, but this does not necessarily imply that the supplier enjoys market power, as the relationship between the primary market and the after-market may be such as to effectively restrain the supplier's conduct on the after-market (e.g., a supplier's charging high after-market prices may adversely affect its sales on the primary product market). The examination of after-markets accordingly focuses on how the relationship between the primary market and the after-market impacts on whether the supplier holds a dominant position on the aftermarket and the factors that will be taken into account by the Commission in this assessment. The Discussion Paper also draws a distinction between those customers that may purchase the primary product in the future and those customers that have already purchased the primary product. Competition on the primary market may protect future customers from potentially harmful conduct by the supplier on the aftermarket, but may not protect existing owners of the primary products from harm if the supplier changes his commercial policy on the after-market (e.g., by raising prices). The key to assessing whether competition on the primary market will protect future customers is the extent to which future customers make "life cycle" pricing decisions, by taking after-market prices into account in their decision to purchase products on the primary market. However, competition on the primary market may not restrain a supplier's conduct on the after-market, particularly with regard to existing customers of the primary product who are effectively "tied in" to purchasing the after-market product. The supplier may change its commercial policy on the after-market (e.g., through raising prices) to take advantage of the installed base of existing customers effectively "tied in" to purchasing the after-market product (so-called "installed base opportunism").

proven, the Commission would simply have to demonstrate that the termination is likely to have a "negative effect on competition" in order to establish a *prima facie* case that the conduct is abusive. The dominant supplier could, thereafter, only escape a finding of abuse by showing that the refusal is justified objectively or by efficiencies.

If the dominant supplier has not previously supplied the input to a potential buyer, an additional criterion is added to the four criteria mentioned above: the input must be "indispensable" to carry on normal economic activity in the downstream market. A facility will be an "indispensable" input, or a socalled "*essential facility*", only when the duplication of the existing facility is impossible or extremely difficult, either because it is physically or legally impossible to duplicate, or because a second facility is not economically viable. Nevertheless, the Discussion Paper correctly points out that "to maintain incentives to invest and innovate, the dominant firm must not be unduly restricted in the exploitation of valuable results of the investment. For these reasons the dominant firm should normally be free to seek compensation for successful projects that is sufficient to maintain investment incentives, taking the risk of failed projects into account. To achieve such compensation, it may be necessary for the dominant firm to exclude others from access to the input for a certain period of time. The risks facing the parties and the sunk investment that must be committed may thus mean that a dominant firm should be allowed to exclude others for a certain period of time in order to ensure an adequate return on such investment, even when this entails eliminating effective competition during this period" (# 235).

The Discussion Paper clearly states the priority of IPRs protection saying that "[i]mposing on the holder of the rights the obligation to grant to third parties a licence for the supply of products incorporating the IPR, even in return for a reasonable royalty, would lead to the holder being deprived of the substance of the exclusive right". Hence, another more restrictive criterion is added in the case of a refusal to license IPRs: the undertaking which requests the licence should intend to produce new goods or services not offered by the owner of the IPRs and for which there is a potential consumer demand. This additional criterion is in line with established case-law, but the Commission introduces an exception to this criterion. It states that a refusal to license IPR-protected technology which is indispensable for follow-on innovation may be abusive even if the license is not sought to directly incorporate the technology in clearly identifiable new goods and services since "[T]he refusal of licensing an IPR protected technology should not impair consumers' ability to benefit from innovation brought about by the dominant undertaking's competitors" (# 240). However, this exception is not motivated by economic analysis and inconsistent with its mainstream theories: there are not serious economic arguments supporting the view that weakening IPRs would strengthen innovation in the long run: while this may happen in the short run, the current approach of the Discussion Paper on this matter may have strong negative consequences for EU innovation in the long run.

Finally, the Discussion Paper states that leveraging market power from one market to another by refusing to supply interoperability information may be abusive. "Although there is no general obligation even for dominant companies to ensure interoperability, leveraging market power from one market to another by refusing interoperability information may be an abuse of a dominant position" (#241). The Commission will, even if such information is considered a trade secret, not apply the same high threshold as regards IPRs. However, there is no guidance on the lower standards that the Commission will apply and on the definition of "information needed for interoperability" and this statement appears to open doors to a systematic possibility that innovative firms are forced not only to reveal IPRs but even trade secret. The same uncertainty induced by this ambiguous wording is likely to jeopardize the incentives to invest in R&D with dangerous consequences for (future) consumer welfare, exactly the opposite of what the Discussion Paper was aiming to.

© 2006 ECG