

PREDATING IN THE INFORMATION SOCIETY

Candidate number: 4
Supervisor: Katinka Mahieu

Number of words: 19.895
Date of submission: February 10th

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I. Introduction

Predatory pricing deals with the issue of pricing products or services at levels below a “reasonable” measure of cost. In theory, predatory prices are deemed a threat to the survival or entry of efficient competitors because they are set at a level that only responds to the purpose of eliminating competitors or deterring their entry.

The latest liberalisation trend in EU in the telecom industry combined with the particularities of the sector makes predatory pricing ¹ an issue of particular interest. The privatisation of previously state-owned enterprises that constituted monopolies has transformed the structure of the telecom market. Many small firms (SMEs) have entered and cut off market shares from ex-monopolists that nevertheless still remain dominant in most countries.

The problems related to the subject matter are the lack of economic consensus on the benefits or harms of predatory pricing and the difficulty of determining an adequate cost measure, under which presumptions can be established that prices cause an injury to competition.

First, predatory pricing can hinder the development of SMEs, but at the same time low prices are the stamp of competition theory. Some economic schools find predation positive. In the legal arena, Courts and administrative institutions have swayed along with the contradicting theories that predatory pricing could be rational or irrational and thus used a different standard in their decisions. The complexity linked to the economic models that have studied predation and the need to balance different interests makes it difficult to establish legal rules. Does competition in the telecommunications sector maximise the allocation of resources or should a monopoly control the distribution of scarce resources?

Secondly, the cost measures used in traditional industries are not apt for the telecoms because they are network economies with high fixed costs and very low variable costs and hence complaints cannot be properly assessed on the basis of the current case law.

The European Union has chosen a very pro-active approach towards regulating the market forcing dominant companies to give access on a non-discrimination basis and reflect costs on their prices. Several directives impose limitations that explicitly identify the effects of predation in non-competitive markets.

The hypothesis of the paper is to find out whether case law based on article 82 of the TEC is sufficient to deal with predatory pricing in the telecommunications industry or if sector specific rules should be applied complementarily. Secondly, we examine the need for additional legislation.

We look at predatory pricing generally, in traditional industries and specifically in network economies such as the telecoms, both from a legal and economic perspective with reference to competition and sector specific law, American and European case law and Commission decisions.

¹ The acronym PP will be used instead of predatory pricing in some parts of the text

The thesis is divided into seven sections. Section II.1 explains how economics define predatory pricing and gives examples that illustrate the different theories. Section II.2 discusses the current legal framework on predatory pricing in the EU and US. The purpose is to compare both approaches and show how US case law has influenced European Commission decisions. Section III exposes the specialities of network economies and the legal framework governing the access pricing in the telecommunications sector. Section IV looks at the latest trends adopted by the European Court of Justice in two Merger cases that have a connection to predatory pricing. In Section V we debate the hypothesis of the thesis and in section VI we propose a legal rule. We show the *extra-judice* possibilities available to companies to combat abusive behaviour in section VII and finally, in section VIII we draw our conclusion.

II. Predatory pricing: Economics and Law

II.1 The economic theory of predatory pricing

Generally, predatory pricing occurs when a dominant firm prices its products or services at levels that do not cover their costs, during a “sufficient” period of time and with the purpose of eliminating, disciplining, or inhibiting competition². The level of the prices and the length of time will be essential in determining the unlawfulness and predatory character of the practice.

The dominant firm and its rivals, being equally efficient, will incur significant losses. However, the dominant expects to recover them with future profits from a reduction in the market shares of rivals. A predatory price is profit maximizing because of its ulterior exclusionary effects, which are higher prices and reduced output.³ In Europe, Article 82, letter b prohibits any behaviour that limits output.

It is not the price level alone that is decisive but the intention to make a rival leave the market to regain market power.⁴ PP strategy is only profitable when the aftermath of the price war between a dominant firm and a smaller rival, brings about prices above competitive levels as a result of there being only one or two firms (monopoly, duopoly) controlling production.⁵

In the decades preceding the 80s economists rejected predatory pricing as an irrational and unprofitable strategy. Even today there are those who share this opinion. John Lott, for example, argues that managers lack the incentive to engage in PP because their bonuses depend on short run profits, which vanish otherwise.

² Janusz A. Ordover & Robert D. Willig: “An Economic Definition of Predation: Pricing and Product Innovation”, 91 YALE L.J. 8 (1981)

³ See Luis M.B. Cabral and Michael H. Riordan: “The Learning Curve, Predation, Antitrust and Economic Welfare”, 45 J. INDUS. ECON. 155 (1997)

⁴ Cabral and Riordan, 1997

⁵ Janusz A. Ordover & Robert D. Willig: “An economic definition of predation: pricing and product innovation”, Yale Law Journal, 91 (1981). They maintained that PP can only be a profitable business strategy if it eliminates one or more competitors.

There are, however, amongst sceptics those who admit that PP is plausible but they maintain that there are a number of counterstrategies to fight predation like self-policing, i.e. market actors are in a better position to predict the outcome and consumer response to price undercutting than for instance law makers or judges.⁶

Economists in the 1980's constructed new theories on predatory pricing that assume the premise that there is no such thing as perfect information, which is a precondition for a "perfect competition" model. Information is imperfect and asymmetric and strategy can rend profits to a predator as experimental studies have shown⁷.

The "game models" theories show that predation can be part of a rational, profit maximizing business strategy, if there are either information asymmetries on the horizontal level between incumbents (old monopolies) and entrants or in the vertical relationship between firms and investors. This has so been the case in the shipping, tobacco, oil and, above all, the telecom industry.⁸

II.1.1 The Chicago School

The Chicago school views predatory pricing as irrational for four reasons:

1- It is difficult to earn extremely high profits because low entry barriers allow competitors to subsist even in a climate of predatory prices. If prices push an entrant out, the perspective of higher prices later can bring the company back.

2- There can be high barriers to exit such as sunk costs (unrecoverable costs used to establish the business at first) that make an entrant stay in the market despite losses in order to not lose those initial investments. Low exit barriers, as a corollary of entry obstacles will also make PP unprofitable and encourage re-entry of companies.

3-An effective company can obtain external funding from investors even if the dominant firm engages in PP due to forecasts of future profits⁹

4-PP is unlikely because it is cheaper to take over the prey since low profits will undervalue the victim and thus make the acquisition easier.¹⁰

⁶ Donald J. Boudreaux and Andrew N. Kleit

⁷ The predatory behaviour allows a dominant firm to deter entry in other segments, where firms are misinformed about the real profitability of the company. The predator seeks to convince the rival that entry in a particular market is unprofitable through the conveyance of distorted information from other markets.

⁸ In USA, Mogul Steamship Co, American Tobacco Company, Rockefeller Standard Oil Company. See esp. case study Southern Bell Telephone by David F. Weiman & Richard C. Levin (102 J. POL. ECON).

⁹ Robert Bork, *The Antitrust Paradox* (New York: Basic Books, 1)

¹⁰ John McGee *Predatory Price Cutting: The Standard Oil Case*, 1 J. L. & ECON. 137 (1958) and *Predatory Pricing Revisited*, 23 Journal of Law and Economics

II.1.2 Game theoretic models Vs. Chicago School

II.1.2.1 Financial market predation

It takes the view that in a predatory situation a victim will not obtain financial support from bank institutions since they terminate loans when profits are low, as they do not want to risk not recovering their credits. The bank does not know whether the lack of profits is due to inefficiency or predation and even if it did know, it would not be able to grant a loan under such circumstances.

The strategy is possible because of imperfections with capital markets. Investors might find it difficult to finance in such situations where the risks are too high and the creditors can be over-exposed.

Financers often will impose results/profits obligations which if not met will mean the termination of the loan. They might also threaten to liquidate the firm or refuse to extend additional financing. Alternatively, investors can decline to purchase further equity if returns are low. Hence, predatory pricing becomes viable when a predator uses these situations to stop the financing of a rival firm.

A problem linked to financing arises in the case of start-up companies, particularly acute in the telecom sector, as most of the new companies have only recently started their trajectory. Initially there will always be unavoidable losses such as the investment in the building of a net, purchase of equipment or land, which might be perceived as bad performance by lenders who may decide to not prolong further the financial contract.

A predator can exploit these circumstances by cutting prices and depleting the prey's resources to pay back the loans and even the capacity of earning some profits. The absence of profits will reduce the value of the prey's assets and thus hinder the possibility of securing future loans. Lenders cannot foil this problem because they lack full information on the causes of the poor results and cannot therefore identify the predation strategy.

Predation under this model is characterized by the presence of 3 basic elements: The prey's dependence on external financing, contingency of funding upon performance and the ability of the predator to cross-subsidise its own losses.

II.1.2.1.1 Example: The SAS case

This is a predatory case that contains both financial and reputation effect predation elements. It involves two airlines, a small firm called Coast Air and a dominant, the Norwegian filial of Scandinavian airlines (SAS).

a) Facts

Coast Air entered the route Oslo-Haugesund (OH), already served by SAS, on June of 2003, running between two and three daily flights with a passenger capacity of 48 seats.

SAS had a market share of 88% in that route and there were found market barriers, according to the *Konkurransetilsynet* (Kt).

Evidence surfaced that SAS did not cover its variable average costs during a period of 4 months. SAS had cut down prices sharply on that route to meet competition by Coast Air, selling tickets at much lower average prices than in the rest of the national routes in Norway.

SAS began predating already in to the period June 2003-2004. Revenues were considerably lower than in previous years when SAS was the only operator of the route.

SAS earned an average 436 NOK per economy class ticket sold in the route OH in May 2004 and average revenues during the investigation period were of 681.25 NOK for every economy class ticket sold, according to calculations based on the authority's report.

Records of prices provided by the Norwegian newswire Ntb show that SAS put up prices by 10 per cent in the entire south of Norway during the months of July to September 2004.¹¹

SAS claimed that it would have lost revenues from other flights if capacity in OH had been reduced due to network effects.

Kt found however that SAS already counted on potential losses of network percentages (i.e., loss of customers in other routes, reputation effects) if the flight route O-H was shut down.

The authority calculated that a reduction in the number of flights connecting those two points would lead to a very small loss of SAS total network and therefore the low prices only were rational if seen in connection with a plan to eliminate competition.

During a raid, Kt discovered internal SAS documents revealing calculations that foresaw an improvement in their results after they regained the monopoly of the route. There was an apparent motive to hurt the competitor on an isolated route to dissuade other rivals such as Norwegian and other potential newcomers from entering the relevant market or expand to other routes.

Another information item shows that after the fusion of SAS and Braathens, they announced a list of new prices for the spring season 2004, around the same time when CA pulled from the OH route. In August 2004, SAS increased prices by 35%.

Coast Airs' cheapest flight price on the OH route was 284 crowns at the time while SAS-Braathens' cheapest offer was 308 crowns, according to NTB. SAS' president, Petter Jansen, was quoted saying that those prices could only mean that the company was not dumping since they priced above their competitors.

Today, a year after CA pulled out, the cheapest offer from SAS in the route OH is 418 crowns, buying a long time in advance, according to their web page, 118 crowns more expensive than previously. The route Oslo-Bergen has the same price.

¹¹ "Prices in southern Norway are today around 30 to 40 per cent lower than in the same period last year. Therefore, this price correction -10% higher- seems very natural and prices will continue to rise until air companies start earning money again".

b) Financial predation

The price undercutting took place at an essential starting phase for Coast Air. It entered the market with prices that undercut SAS and maintained them at a low level during the whole period they competed.

Coast Air's average prices on OH were between 2 to 9 per cent lower than SAS until November when it had to renounce to its strategy. SAS, who had additionally expanded capacity in that route, with the result that many of its flights being half empty, could sustain the price war longer due to better liquidity.

Coast Air had during the years 1999 to 2003 an accumulated deficit of 65 million crowns and as pointed out by SAS, it had problems in finding suppliers of capital which it needed dearly. KT argued that a predatory strategy is more likely to succeed when the newcomer is weak and for that reason the incumbent or dominant has an extra duty of prudent behaviour towards the newcomer.

In a telephone conversation with Andrè Kidess, chief economist of Coast Air, he explained that investors were well aware of the predation scheme. "The prices offered by SAS were very low and we could not cover our own variable costs. For us at that moment it was more costly to have the planes on the air than in the ground", said Kidess. He also stated that "low prices from SAS were the cause- of our losses- and we-management and board- were well aware of this situation during several months".

The economist added that Coast Air had one regular flight per day and that their variable costs included the fuel, the ground landing, environmental costs, taxes and charge costs, crewing (salaries for pilots and cabin) and booking costs. During 3 months these costs were above their earnings.

Coast Air had a "quite difficult situation financially". Two of the owners -Harry Åsse and Margaret Hystad- who had invested their own personal capital in the company withdrew in august 2004, and a third one, Trygdve Seglem, injected more capital and gave Coast Air more liquidity.

Kidess recognised that at first the financial situation was much better than at the end of the period competing with SAS on the route and that they never could have foreseen how fast and how deep their losses occurred.

II.1.2.2 Signalling theories of predation

The predator sells at low price to deliberately mislead the victim to believe that market conditions are unfavourable. Within these theories we find the reputation effect predation, the test market and signal jamming and cost signalling.

II.1.2.2.1 Reputation

The predator reduces the price in a market to induce the prey to believe that the predator will cut prices in its other markets or in the predatory market itself. The predator seeks to establish a reputation as a price cutter.

Scherer¹² maintains that “sharp price cutting in one market” can have a demonstration effect that influences the behaviour of actual or potential rivals in other markets. If rivals fear from past actions (monopolist’s history) in market A (i.e. fixed telephony) that entry or expansion in market B (i.e. mobile telephony) and market C (broadband access) will be met by sharp price cuts or other rapacious responses, they may be deterred from entering or expanding. Then the incumbent’s benefit from predation in A will be supplemented by the reduced competition in B and C, where it can concomitantly augment its market shares.

Other economists such as Selten or Nash argue that the above is not possible in game theory models. In a simple environment, there are no means by which rational strategies in one market can influence the behaviour of other independent markets, since there is a missing mechanism that can connect the two, respond these economists.¹³

David M. Kreps (K) and Robert Wilson (W) suggest however that the lacking component can be “imperfect information”. Their hypothesis is that the incumbent firm that enjoys market power will employ rapacity methods to fight off competition. The cost of the strategy is insignificant compared to the potential benefits gained from deterring challengers and increasing reputation (in Scherer’s sense).

K and W examined two different models. The first one is a market where a monopolist faces a succession of potential entrants and these are unsure about the incumbent’s results. Their numbers tell them that no matter how little the chances are that the monopolist “really” benefits from predation, the entrants nearly always avoid entering for fear of the predatory response.

In a second model, with one entrant and several chances of penetrating the market plus the added feature that the incumbent also ignores the entrant’s payoffs, they conclude that the situation is similar to a price war because the entrant also has a reputation to protect and both firms may engage in battle. Each one employs aggressive tactics in an attempt to force the other to acquiesce entrance or face expulsion. Both firms would initially incur short-run losses.

They have shown that in a game with imperfect information, the strategy of a strong monopolist is to always fight entry, whereas the weak monopolist will either consent to entry or fight depending on an assessment of the probabilities of payoffs it will get, which are in turn based on an assumption of the strong or weak character of the opponent, as opposed to Selten, who thinks that the entrant always enters, no matter what and that the weak monopolist always accepts entrance.

¹² F.M. Scherer, Predatory Pricing and the Sherman Act: A Comment, 89 Harvard Law Review 869 (1976).

¹³ Game theory is a branch of applied mathematics that uses models to study interactions with incentive structures (“games”). It encompasses decisions made in an environment where various players interact strategically (Wikipedia)

Paul Milgrom has pointed out that predation may occur even if every player in the game knows the payoffs of the monopolist, as long as this knowledge is not common knowledge. Milgrom refers to the case where an entrant knows the monopolist's payoffs, but ignores whether other rivals also share this knowledge.

The conclusion reached by all these authors is that if the situation is repeated, so that it is worthwhile to maintain or acquire a reputation, and if there is some uncertainty about the motivations of one or more of the players, then that uncertainty can substantially affect the play of the game.

Reputation effect predation always involves two markets: a demonstration market, where the incumbent or dominant firm exhibits its power with very low prices and concomitant contrived low costs, and a recoupment market where he will benefit from absence of or little competition by rivals who fear more predation in that market.

II.1.2.2.1 Example: Tetra Pak¹⁴

The Tetra Pak consortium is one of the world leaders in the field of the packaging of liquid and semi-liquid foods in cartons. The group operates both in the field of the non-aseptic packaging of fresh products and in the field of the aseptic packaging of long-life products, and holds a virtual monopoly in the latter.¹⁵ In the aseptic sector, Tetra Pak manufactures the "Tetra Brik" system and on the non-aseptic, the "Tetra Rex", competing with the "Pure-Pak" carton produced by the Norwegian group Elopak.

Tetra Pak competed with Elopak in the Italian market. Elopak complained that Tetra Pak had attempted over the years to reduce Elopak's competitiveness in Italy by engaging in trading practices, which, for an undertaking in a dominant position, must be deemed to be abuses.

According to Elopak, these practices essentially involved the sale of 'Rex' cartons at predatory prices, the imposition of unfair conditions on the supply of machines for filling these cartons and, in certain cases, the sale of this equipment at predatory prices as well.

The Commission found that Tetra Pak held a 95% share of the aseptic sector and between 50 to 55% in the non-aseptic sector, which was oligopolistic. Elopak held, in 1985, 27 % of the market.

Tetra Pak's aseptic brick accounted for 70% of its profits and Rex made up 11%. The Rex carton was experimenting heavy losses overall in the EU and particularly in Italy, where Tetra Pak resold the product at prices, almost 35 % lower than the purchase price during a 7 year period.

¹⁴ 92/163/EEC: Commission Decision of 24 July 1991 relating to a proceeding pursuant to Article 86 of the EEC Treaty (IV/31043 - Tetra Pak II)

¹⁵ Judgment of 06/10/1994, Tetra Pak / Commission (Rec.1994,p.II-755)
(SVXVI/II-1 FIXVI/II-1)

The Commission investigated the facts and discovered that these losses were so great that the selling price came nowhere near to covering even direct variable costs and, in some years, covering no more than the cost of raw materials.

Sales of Rex cartons, on the other hand increased at an exceptional rate, while Elopak's sales of the Pure-Pak carton stopped increasing and began to decrease.

Elopak's share of the Italian market in non-aseptic cartons was 25 % in 1981 but fell to 17,5 % in 1986. Conversely, Tetra Pak's aseptic market share, increased to 80,5 % by 1986, and that of Rex cartons increased up to 38,5 %. Tetra Pak could afford to sell at 'eliminary' prices, thanks to its dominant position on the aseptic packaging market, from which it drew virtually all its resources.

Tetra Pak's market share increase in the aseptic sector presents many of the symptomatic effects of the reputation predatory predation as defined above, i.e. price cuts in one market affects in the other one.

The Commission wrote in the decision that everything pointed to Tetra Pak deliberately selling at a loss as part of a deliberate strategy of conquering the Italian non-aseptic packaging market, on which the Pure-Pak had succeeded in acquiring a position.

II.2.2.1.2 Example 2

The SAS case above presents signs of reputation predation because SAS also competes with its main rival Norwegian in the national flight map. Predation in OH would have had given SAS a reputation of aggressive opponent in all the other low fare routes. Comparing SAS' prices in OH with Norwegian's prices in a similar market we may infer the existence of a PP strategy by the former.

Norwegian's cheapest offer today in a distance covering 450 kilometres between Oslo and Bergen costs 367 crowns. Norwegians' results after taxes for the second semester of 2005 were of 14, 8 million crowns. The result of dividing operating revenues by the number of passengers that flew with Norwegian during the period of April-June was of 612 crowns per person, only 69 crowns less than SAS but probably with lower costs.

II.1.2.2.2 Test market and signal jamming

This sort of predation takes place in the following way: A newcomer wants to introduce a brand in a specific market to compete with an existing one. Instead of entering in all of the markets where the competitor has business, he will refrain to a "test-market" because the purpose is to analyze consumer response to the product offered.

The predator then sabotages this attempt by either cutting prices secretly (selective rebates), in which case we will be dealing with general test market predation, or openly, and here we are facing a specific signal jamming predation.

Under the first one, the entrant believes that demand is too low and thereby gives up entry since he does not consider it profitable. In the second type, the newcomer cannot assess adequately the

response to the product due to the price cuts and thus the result would be the same as in test market predation. He cannot tell whether demand is high or low under normal circumstances. The only difference is that under signal jamming, the entrant has knowledge of the predation scheme and might consider entry depending on additional factors, such as financing, perspectives of gains and an evaluation of its own product or service.¹⁶

II.2.2.2.1 Example: Hypothesis

A company, “Nortron” has patented a new mobile service allowing customers to connect to a chat on the Internet and talk to strangers by entering a code from your mobile. The user only pays the cost of sending a sms to a number and can chat freely one hour.

A company, “Smype”, dominant on the fixed telephony and mobile markets finds out Nortron’s intentions through a disloyal employee and starts offering mobile access to internet 24 hours a day during a month at flat rate of 100 Nok per month.

However tempting Nortron’s offer may be customers will prefer Smype.

Nortron’s will give up entry and lose the time and money invested in the patent. If Smypes’ offers are done secretly, i.e. sending selective letters or e-mails to clients, then we are dealing with test-market predation.

On the other side, if Smype is open about its price reductions and publicises the rebates, then we are contemplating a case of signal-jamming predation.

II.1.2.2.3 Cost signalling

A predator reduces prices to induce its competitor to believe that it has lower costs. The prey uncertain as to the reasons for the low prices considers the probability of the predator being more cost-efficient than him. The competitor calculates its hypothetical returns on the basis of those costs and the chances of gaining market shares and consequently does not enter or exits the market.

II.2.2.3.1 Example: Hypothesis

A company called “Mappy”, dominant in the fixed telephony market discovers a new way to substitute the wire cable with a modern plastic fibre that multiplies access and interconnection capacity by 100 and reduces costs likewise. Mappy has concluded a deal with a plastic fibre producer for a constant supply and starts a campaign marketing its services at halved prices. Mappy, in compliance with national regulations is not required to give access to the plastic fibre net to any of the other competitors and can freely price its services.

Another company, called “Bunny”, with a 5 pct of the market in fixed telephony decides to stay in business a while but after 5 months of losses and a 80% reduction of customers decides to abandon. This would be lawful.

¹⁶ Steven C. Salop & Carl C. Shapiro, A Guide to Test Market Predation, 1980

Cost-predation would occur when Mappy's price reductions had no relationship with the new technology. Bunny suspects that Mappy has lowered prices to either discipline them or force them to exit but it does not hold full information. Mappy conducts a probability assessment considering the impact of the hypothetical cost reduction on the market and concludes that it is not profitable to stay. This would be unlawful and national authorities can act.

The problem underlying cost-signalling predation is that in regulated markets such as the telecommunications sector, this theory plays a little role because competition authorities impose different obligations to dominant companies such as publication of financial reports with details on cost and price accounts that prevents this strategy.¹⁷

II.2 The legal theory of predatory pricing

II.2.1 US rules

Predatory pricing on the other side of the Atlantic is covered by section 2 of the Sherman Act, that states, "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$10,000,000 if a corporation, or, if any other person, \$350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court".¹⁸

It is superfluous to say that in the US predatory pricing rules owe their development almost fully to case-law and cases investigated by the Federal Trade Commission (FTC). Additional legal sources are sections 13, letter a and 13a of the Robinson-Patman Act of 1936 amending section 2 a of the Clayton Act, 15 U.S.C. of 1914 dealing with price discrimination:

"It shall be unlawful for any person engaged in commerce, ...either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality..."¹⁹

The following passages of the law have been edited to ease the comprehension of the text:

1. It shall be unlawful for any person engaged in commerce to discriminate, in a contract of sale of goods of similar characteristics, between purchasers by granting bigger discounts, rebates, allowances or advertising service charges to a specific purchaser in detriment to the others.
2. It is also unlawful for a person engaged in commerce to sell goods at prices lower in some places than other for the purpose of destroying competition, or eliminating a competitor or to sell goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor.

Number 2 prohibits predatory pricing.

¹⁷ Directive 2002/21/EC on a common regulatory framework. Directive 2002/19/EC on access and interconnection

¹⁸ <http://www.usdoj.gov/atr/foia/divisionmanual/ch2.htm>

¹⁹ idem as note 45

In USA the passage of the Patman Act led to a considerable amount of complaints succeeding in court where plaintiffs, mostly small sized undertakings, were awarded protection against price discrimination by larger commercial entities. The predation theories were still incipient and therefore many took advantage of the Courts' inexperience to remain in business despite inefficiencies.²⁰

But with the publication of a landmark article known as the Areeda-Turner rule²¹ the climate suffered a drastic blow with lawsuits' success rates passing from 77% to 8% according to studies undertaken by Koller and Kovacic²²

The article proposed a standard cost floor based on average variable cost under which predation was presumed, but was later criticised for not taking into account the element of strategy inherent in the predation plans of a firm whose purpose is to recoup losses in the near future.²³

Professors Ordober and Willig enriched the theory with hypothesis that consider competition dynamics: "predatory objectives are present if a practice would be unprofitable without the exit it causes, but profitable with the exit."²⁴

However, the rule was inappropriate in markets with entry barriers such as scale and scope and other authors added that denying a rival sales weakens its ability to compete even if it does not shut them down entirely.²⁵

In Europe the latter school of thought seems to have gained great acceptance amongst scholars and certainly in the Commission and the ECJ²⁶ with cases reiterating that the predatory pricing has for effects to eliminate a competitor or discipline it: "has the effect of hindering the maintenance of the degree of competition"²⁷ or "deny other producers access to the market"²⁸

The main shortcomings of the Areeda-Turner rule were its focus on the temporary effects of PP and the inaccuracies linked to the AVC price test, which benefited the alleged misfeasors. Besides, it has no effective application on network markets such as the telecoms where sunk and fixed costs can be enormous but average variable costs, i.e. the additional cost of producing one unit extra of output, can be close to 0.

In United States, most of the Circuit Courts (Courts of Appeal in Europe) applied a stringent test of the AT rule in predatory cases where prices below AVC were presumptively unlawful, above

²⁰ See Bolton, cited earlier

²¹ Areeda, Philip E. and Donald F. Turner (1975)

²² Rolland Koller (1971) and James D. Hurwitz & William E. Kovacic (1982)

²³ "Predatory Pricing: a strategic and welfare analysis", Williamson O. in 87 Yale Law Journal, 1977

²⁴ See note 6 supra, at 9

²⁵ David Evans and Richard Schmalensee (2000), Joseph Farrell and Michael L. Katz (2001), Richard J. Gilbert and Michael L. Katz (2001) and many others.

²⁶ European Court of Justice

²⁷ Case 85/76 Hoffman-La Roche v Commission, ¶ 91 and Case C-62/86. Akzo v. Commission, ¶ 69

²⁸ Case 85/76 Hoffmann-La Roche v Commission, ¶ 90

ATC, lawful and prices between those two were a priori lawful but it could be refuted with proof of intent. In Europe all case law since Akzo actually follows these standards.

II.2.2 Case Law

II.2.2.1 Matsushita Elec. Ind. Co. v. Zenith Radio, 475 U.S. (1986)

This case involved claims of predatory pricing in the American domestic market of television sets by Japanese-owned American companies who leveraged their market power (adjacent market or recoupment market) from the Japanese domestic market.

The US Supreme Court's *ratio decidendi* was that the plaintiffs had not presented direct evidence supporting their claim²⁹ that the defendants were involved in a predatory scheme and dismissed the suit basically on three “unfortunate” grounds:

1- There was no logical motive to predate because predatory pricing is economically unreasonable³⁰: “Predatory pricing conspiracies are by nature speculative. They require the conspirators to sustain substantial losses in order to recover uncertain gains”³¹

The Court citing Bork and McGee said that a realistic PP strategy implies that “the future flow of profits... must then exceed the present size of the losses”³² and that “the success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain”³³

2- The relation between the domestic markets in Japan (recoupment market) and USA (predatory market) was irrelevant: “There is nothing to suggest any relationship between... profits in (one market) and the amount it could expect to gain from a conspiracy to monopolize (another) market. A conspiracy to increase profits in one market does not tend to show a conspiracy to sustain losses in another”.

3- An abuse of collective dominance is virtually impossible.

The US Supreme Court, in contrast with the European case law³⁴ says that collective predation is more rare because it is difficult to allocate the losses gains of predation and each individual predator has a strong incentive to cheat the others to let them sustain the overall losses.

In support of this opinion the magistrates said that the two biggest shareholders of the TV-set retail market after 20 years of alleged predation were the initial plaintiffs, but failed to consider

²⁹ “claims that make no economic sense, respondents must offer more persuasive evidence to support their claims than would otherwise be necessary”, at page 587

³⁰ “The court failed to consider the absence of a plausible motive to engage in predatory pricing”, sections III and V.

³¹ Letters c) e) and section IV-A, at page 595

³² R. Bork, *The Antitrust Paradox* 145 (1978).

³³ McGee *Predatory Pricing Revisited*, 23 *J. Law & Econ.* 289, 295-297 (1980).

³⁴ *Maritime Belge*

the significance of the collective Japanese dominance (50%) gained during that time, originally 1/5.

The Matsushita decision is a clear example of Americas mistrust to the application of antitrust rules that may interfere with the principles of a free market. The judges, in a very strict interpretation of the recoupment requisite, said that two decades of losses had to be recouped during an equivalent long period of time³⁵, but did not justify the statement.

Zenith could have had better probability rates of getting a favourable ruling if they had filed an AD complaint instead, since the producers of TV sets in Japan and the importers or distributors in the USA were related.

The lawyers of Zenith should have also provided more “smoking gun evidence” of the Cartel behaviour by the Japanese firms instead of speculative theories that can never be proven in Court.

II.2.2.2 Brooke Group v. Brown & Williamson Tobacco, 509 U.S. 209

This is a landmark predatory pricing (signal predation) case in the United States involving two of their major tobacco companies: Liggett, manufacturer of the known brands such as Chesterfield or Lark and R.J Reynolds/BW, producer of Camel, Winston or Lucky Strike.

Liggett had weakened considerably its position in the tobacco industry with market shares plummeting from 20% to 2% in the 80s and it “was on the verge of going out of business”. To surmount the hard times Liggett began to sell an innovative generic type tobacco “white and black cigarettes” and soon became dominant with 97% of the market shares and over 4% of the global tobacco market in the US until 1984, year when Reynolds/BW decided to enter. The generic market was the fastest growing in the US. The two companies declared each other war.

Ultimately, Liggett filed suit against BW for violating antitrust laws, arguing that BW sold below cost and offered discriminatory volume rebates to wholesalers to force Liggett raise prices and follow the alleged oligopoly pricing (tacit collusion) applied by the rest of competitors (Phillip Morris and others who entered later).

The Supreme Court’s decision concluded, in essence, that BW had not caused injury to competition because Liggett had not provided sufficient evidence demonstrating the casual link between the predatory scheme and a rise in prices to supracompetitive or oligopoly levels. Failure to prove this chain of causation also meant that the plaintiff had failed to provide evidence of the benefits gained by BW’s predation (recoupment).

The Court recalls in its opinion, delivered with 6 votes in favour and 3 against, that according to the RPA rebates are only unlawful when there is a “reasonable” possibility that they harm competition³⁶

³⁵ “...because the alleged losses have accrued over the course of two decades, the conspirators could well require a correspondingly long time to recoup”, at IV-A of the said decision, page 592

³⁶ II-A

The SC³⁷ states that a unlawful predatory pricing consists on two indispensable elements: proof that a firm's own prices are below an appropriate measure of costs (1) and proof of recoupment (2).

(1) Above-cost prices that are below general market levels or the competitor's costs are not unlawful³⁸

“The exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting”

The Court righteously omitted pronouncing which measure of cost is the appropriate since this should be the task of economists, not lawyers, and the market and their actors are in a much better position to determine that end.³⁹

Justice Kennedy reminded the parties that the purpose of the antitrust laws is not to protect inefficient competitors but the competition process in order to guarantee consumer welfare.

"Low prices benefit consumers regardless of how those prices are set. (...)To hold that the antitrust laws protect competitors from the loss of profits due to such price competition would, in effect, render illegal any decision by a firm to cut prices in order to increase market share. The antitrust laws require no such perverse result."⁴⁰

(2) Proof that the competitor had a “reasonable prospect” or a “dangerous probability” of recouping its investment in below-cost prices.

Recoupment is defined by the SC as “the ultimate object of ... predatory pricing... the means by which a predator profits from predation” who adds that otherwise PP brings about low prices which is a “boon to consumers”.

In the specific case recoupment could only be possible if PP drove “the competitor from the market or rose prices to supracompetitive levels within a disciplined oligopoly”.

The SC admitted the likelihood that below-cost pricing could achieve those goals but it was uncertain as to their capability of “injuring competition in the relevant market”.

The magistrates reiterated the Matsushita condition that recoupment had to compensate “the amounts expended on the predation” including current interest rates. The statutes however do not require a recoupment. Injury to competition is already done by acquiring market power through unlawful means and losses can be compensated by the aggregate net gain in the general tobacco industry.

³⁷ Supreme Court

³⁸ See *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340 (1990)

³⁹ "Lawyers know less about the business than the people they represent. . . . The judge knows even less about the business than the lawyers." Easterbrook, *The Limits of Antitrust*, 63 *Texas L.Rev.* 1, 5 (1984)

⁴⁰ *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 117, at 116

The decision citing *Matsushita* states that PP is unlikely and “highly speculative” in a collective dominance scenario⁴¹. However, they do recognise that it is possible which is a significant step forward:

“An oligopoly's pricing may provide a means for achieving recoupment...and a predatory pricing scheme designed to preserve or create a stable oligopoly can injure consumers in the same way as one designed to bring about a monopoly”

The Court found that *Liggett* had provided evidence of the practice of PP and intent, thus fulfilling the first condition or element but not the second.

“The record contains sufficient evidence which could conclude that *Brown & Williamson* intended this anticompetitive course of events”⁴²

“There is evidence in the record which could conclude that, for a period of approximately 18 months, *BW*'s prices on its generic cigarettes were below its costs and that this below-cost pricing imposed losses on *Liggett*”.⁴³

Judges considered that *Liggett* had not sufficiently demonstrated an injury because it had not proven that *BW* “had a reasonable prospect of recovering its losses through slowing the growth of generics”.

The main flaw of this argument is that for the SC, the only visible sign of injury to the market would have been if growth in the generic segment had stifled. This is the same as saying that only when PP causes a restriction in output is unlawful without examining if prices rise in the aftermath of the war or if there is an inefficient allocation of resources, two clear goals of competition.

In section III number 1, the Court says that prices could not have possibly been supracompetitive, because economics say that such prices lead to a stagnation in the production postponing economic growth, which was not the case because “in the next five years, following the alleged predation, the generic segment expanded from 4% to more than 15% of the domestic cigarette market”.

The main mistake, in the Court's reasoning, is that they consider the immediate effects of PP conduct to analyse recoupment instead of examining the likely effects in the near future. To analyse the future you have to investigate the past and here no analysis of *BW*'s historic data was done.

Another major flaw is that the court failed to analyse the effects on the recoupment market (branded tobacco), i.e. if the growth in the generics was due to a mere shift in demand from the branded one.

⁴¹ IIB

⁴² III A, ¶ 2

⁴³ idem note 70

The relevant question should have been if the tobacco industry in general (relevant market) had slowed its growth, as it seems it did.

The second question would be to find out how the 12% growth in the predatory market after BW's entrance, was shared between the different players. If the dominant companies participated equally in the growth but not Liggett, then a tacit collusion could be inferred.

Justice Stevens gave a dissenting opinion which said that "the fact that a price war had not accomplished its purpose as quickly as intended does not immunize conduct that was illegal when it occurred".

Stevens opined that the statutes do not require recoupment, just proof of predatory prices. He argued that to understand the case the judges should have considered the situation before⁴⁴ during and after the predation period. Namely, the fact that "prices for cigarettes increased in lockstep, twice a year, for a number of years, irrespective of the rate of inflation, changes in the costs of production, or shifts in consumer demand."

The dissenting magistrate found it reasonable that BW had carried out a signal predation scheme to hint "its intentions to its fellow oligopolists", to maintain high prices in the business.

I would suppose, however, that the professional performers who had danced the minuet for 40 to 50 years would be better able to predict whether their favourite partners would follow them in the future than would an outsider, who might not know the difference between Haydn and Mozart.

Finally, Stevens said that the Court's most significant error was to assume that Liggett had the burden of proving either the actuality of supracompetitive pricing or the actuality of tacit collusion, point on which I agree completely.

II.2.3 EU rules

The starting point for the regulation of predatory pricing is article 82 of the EC Treaty which prohibits any behaviour that "directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions" and "limiting production, markets or technical development to the prejudice of consumers".⁴⁵

The three basic conditions included in article 82 and defined later by the European Court are the existence of a dominant company, the perpetration of an abuse and the distortion of trade between member states. In our exercise we will only discuss the element of abuse.

Abuse

A dominant company commits an abuse when it recourses to methods not customary in its business to hinder the existing competition or its growth.⁴⁶ An abuse is an "objective concept" which has several requirements:

⁴⁴ the tobacco industry had enjoyed handsome supracompetitive profits for about half a century

⁴⁵ Letters a and b of the article.

⁴⁶ ¶ 54 Case T-203/01 Michelin V. Commission, 2003 and all the case law cited.

- A- The structure of the market is such that the dominant company can influence the course of events.
- B- The competition is already weak
- C- The behaviour of the company hinders actual or potential competition.
- D- The methods used by the undertaking are not customary in the business and can be qualified as illegal.

The provision names as possible abuses “unfair prices” and “limiting production”, where the latter is usually a consequence of the former. Unfair practices such as below-cost pricing can lead to increased dominance, higher prices and ultimately a limitation of output, stemming from lack of competition.

The Commission’s Discussion Paper on the application of Article 82 to exclusionary abuses⁴⁷ (DP, onwards) describes an abuse as a “conduct capable, by its nature, of foreclosing competitors” and by foreclosure they interpret four situations: first, competitors are not allowed to enter a market, partially or completely, secondly it prevents their expansion, thirdly they are forced to exit and finally if rivals are in a disadvantageous situation as a result of the dominant being able to raise their costs or reduce their demand.

DP specifies that a conduct is only considered abusive when it excludes a competitor as efficient as the dominant. The concept of efficient is, interpretable on a case by case basis and therefore includes companies that are or will be able in a foreseeable future to operate efficiently, because they operate below the minimum efficiency scale or they have not reaped some learning effects.

DP considers a behaviour distorting only when it hinders the existing degree of competition or the growth of the market thus causing a likely increase in prices or their maintenance at supra-profitable levels. To assess this element authorities have to investigate the nature or form of the conduct and its incidence and generally the higher the extent and dominance of the company the more likely that an abuse will be found.

The paper also emphasizes that the anticompetitive effects only need to be potential, “likely” and not only actual and it includes direct or indirect harm to consumers.

Another issue is that DP presumes that harm to intermediate agents creates harm to consumers⁴⁸. This is crucial to our study because in telecoms the injury is almost always caused to wholesalers (intermediate buyers) who rent or buy line capacity to the incumbent. When a finding of injury is made on a operator buying access to the network, consumers will be hurt.

Nonetheless, article 82 does not mention predatory pricing. It is assumed that the wording wraps it up but in reality it is the Court’s case law and the Commissions decisions that have built up the concept. Is it appropriate to let appointed judges fill in the legislative gap? Is article 82 sufficient? We must recall that decisions are only binding to the addressees and have a limited scope. The Commission has however the authority warranted in article 249 TEC to propose laws, i.e.

⁴⁷ ¶ 56 <http://www.europa.eu.int/comm/competition/antitrust/others/discpaper2005.pdf>

⁴⁸ ¶ 59 DP

directives and regulations and hence, could suggest special rules to deal with predatory pricing. The application of article 82 has in some way proven to be sufficient with regard to traditional industry cases but economists deny its validity in telecommunications. The Court's assessment of the Wanadoo and Deutsche Telekom decisions will tell us to what degree there is agreement between the judiciary and the administration.

II.2.3.1 Case law

There is a considerable amount of literature critical of predatory pricing case law in both shores of the Atlantic (Maritime Belge case and American Airlines case⁴⁹) due to a lowering of the abuse threshold from "below-cost pricing" to "above-cost price cuts".

Edlin⁵⁰ says that above cost predatory pricing is possible when the dominant firm prices at levels above its costs but not those of competitors. The reasoning being that the monopoly has "gone down the cost learning curve and produces more efficiently". Williamson⁵¹ states that cost-based rules are inadequate because they do not fit reality of dynamic markets.

The European Court of Justice has developed extensive case law on abuse of dominant position, very much influenced by rulings given in the USA.

Predatory pricing only comprises a little part of the case law and on the specific sector there are a couple of recent decisions by the European Commission: Deutsche Telekom and Wanadoo. The CFI⁵² is trying the first decision after the German company brought an action of annulment or modification against it in July 2003. The latter affair was also submitted for judicial review to the CFI on October 2003.

The two possible tests of predation as defined in Akzo and Tetra Pak⁵³ are:

- A) Where variable costs are not covered, an abuse is automatically presumed
- B) Where variable costs are covered, but total costs are not, the pricing is deemed to constitute an abuse if it forms part of a plan to eliminate competitors.

DP uses the AAC cost benchmarks because prices below it "justify the presumption that there is predatory pricing" and it is practical to calculate. The AAC is preferred to others because it considers losses that could have been evaded by not producing the extra output.

⁴⁹ See Complaint of United States, *United States v. AMR Corp.*, 140 F. Supp. 2d 1141 (D. Kan. 1999) (No. 99-1180-JTM), available at <http://www.usdoj.gov/atr/cases/f2400/2438.htm>. Since 1993, American Airlines offered above cost price cuts and added capacity to its flights in all the routes arriving and departing from the Dallas International Airport where it faced competition from so-called low cost carriers (LCCs).

⁵⁰ "Stopping above cost predatory pricing", Edlin, *Yale Law Journal*, 2002.

⁵¹ See Williamson and Baumol named earlier

⁵² Court of First Instance

⁵³ See European Court of Justice in Case C-62/86 *Akzo Chemie v Commission* [1991] ECR I-3359, paragraphs 71 and 72; Case C-333/94 P *Tetra Pak v Commission* [1996] ECR I-5951, paragraph 41.

Prices below AAC are presumed predatory. Prices above AAC but below ATC are not presumed predatory. This type can be predatory with evidence of intent. In this sense, the Commission uses the “but for rule”, i.e. price is predatory when it does not make sense “but for” the prospect of anticompetitive gain (The Inglis rule).⁵⁴

Regarding procedures, DP defines the period of investigation as the time in which PP has taken place or is expected to take place, if still continuing. In relation with intent (culpa), DP sustains that targeted sales will be “an important part of the evidence of intent” and that evidence of intent and recoupment is not essential to a finding of predation.⁵⁵

II.2.3.1.1 Akzo⁵⁶

This is a predatory pricing case involving two chemical companies, Akzo Chemie and Engineering and Chemical Supplies (ECS), producers of organic peroxides, chemicals used in the plastics industry in the British and Irish markets.

Akzo also manufactured derivatives of benzoyl peroxide; potassium bromate and vitamin mixes, used in the flour industry (as bleaching agents or additives) in competition with ECS and a third company, Diaflex.

The Commission found in particular that AKZO⁵⁷ had threatened ECS with forcing its withdrawal from the market for organic peroxides, offered and supplied flour additives to ECS' s customers at unreasonably low prices, bundled potassium bromate and a vitamin mix (the latter a product which it did not normally supply) at a bait price in a package with benzoyl peroxide to ECS' s customers and maintained, as part of the plan to damage ECS, the prices for flour additives in the United Kingdom at an artificially low level over a prolonged period, a situation which it could survive because of its superior financial resources in comparison with ECS.

The motive for the predatory scheme seems to be the decision by ECS to enter in 1979 the plastics sector where Akzo was also dominant, a business much more profitable to it than the flour additives segment. Akzo wanted “to preserve its position in the plastics sector by preventing ECS from extending its activities to it”.⁵⁸

The ECJ determined that “not all competition by means of price can be regarded as legitimate”⁵⁹.

The Court stated that the cost thresholds applicable in that particular case were AVC and ATC.

A) “Prices below average variable costs...must be regarded as abusive. A dominant undertaking has no interest in applying such prices except (to) eliminate competitors and (...) later raise its prices by taking advantage of its monopolistic position, since each sale generates a loss: the total amount of the fixed costs and... part of the variable costs relating to the unit produced”⁶⁰

⁵⁴ ¶ 114. See *Inglis v. ITT Continental Baking*, 668 F.2d 1014 (9th Cir. 1981), at 1038

⁵⁵ ¶ 113 to 120

⁵⁶ C62/86

⁵⁷ ¶ 9

⁵⁸ ¶ 44 C 62/86

⁵⁹ ¶ 70

⁶⁰ ¶ 71, ed.

This is the first rule theoretically applied by the Commission. The above means that when a dominant company prices at $p < c$ it is abusive only if it has the actual or potential effects of eliminating competitors and increasing prices. Another implication is that the conduct will be abusive if it has the potential effect of introducing a monopoly in the market, i.e. it does not require that the company have monopoly power when the price abuse is perpetrated. Lastly, the Court did not require proof of intent because the only logical business reason to price under costs is to eliminate rivals: “a company has no interest but”.⁶¹

B) “Prices below average total costs but above average variable costs, must be regarded as abusive if they are ...part of a plan to eliminate a competitor. Such prices can drive from the market undertakings which are perhaps as efficient as the dominant undertaking but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them”⁶²

The following elements can be outlined:

Prices above average total costs will only be abusive if:

- There is direct or indirect evidence of the intention to eliminate a competitor.
- The rivals are as efficient as the dominant.⁶³
- The rival has less financial resources.

In relation with accusations of discriminatory or selective pricing the Court found that Akzo had not breached article 82 in connection with some of the offers since purely quantitative rebates are allowed.⁶⁴ These rebates are only admitted when they are based on differences in quality or production costs of those products offered to some customers. Otherwise they are discriminatory.⁶⁵ However, other rebates offered to comparable customers (large independents) that were clearly discriminatory and had no reasonable explanation were unlawful.⁶⁶

The Court also condemned Akzo’s illegal bundling of products (vitamins mixes and potassium bromate) offered to its rival’s customers as part of the plan to make them shift supplier.⁶⁷ This case, as in Brooke also involves the interaction of other players but the Commission had sound evidence of the price cooperation between Akzo and Diaflex which discarded any “meeting the competition” justification.⁶⁸

The message conveyed throughout the text is that predatory pricing is unlawful regardless of which customers are being favoured by advantageous conditions as long as competition is

⁶¹ The Inglis rule

⁶² ¶ 72 ed.

⁶³ The word perhaps means here that without the market distortion they would have been equally efficient. We do not think that the Court intended to protect less efficient companies because it would go against the spirit of competition law.

⁶⁴ See ¶ 119-121

⁶⁵ ¶ 113

⁶⁶ ¶ 114, 115

⁶⁷ ¶ 123-130

⁶⁸ ¶ 135-137

smear. In short, it is irrelevant if prices are maintained artificially low to gain new customers or to keep older ones.⁶⁹

The Court neglected to determine the length of the period of time of PP to amount to an infringement and only said that “by maintaining prices below its average total costs over a prolonged period, without any objective justification, AKZO was thus able to damage ECS”⁷⁰ but it reduced the fine because “the pricing strategy had a limited effect with their respective market shares varying -5% (ECS) and +3% (Akzo)”⁷¹.

II.2.3.1.2 Maritime Belge⁷²

This is a “fighting ships” case involving a series of liner conference companies (CMB and Cewal) and a group of independent ship owners (AIWASI) operating ships between Northern Europe and the western African country of Zaire.

The companies were found in violation of article 81 and 82 for concerted practices (price fixing at dumping rates), selective price-cutting and predatory pricing.

The Zairian authorities adopted an ordinance which granted Cewal the exclusive right to the transport goods between Northern European ports and Zaire, also recollected by an agreement between the national maritime office (Ogefrem, in French) and Cewal.

A special derogation to the Ogefrem agreement allowed the independent company Grimaldi and Cobelfret (GC), founder of AIWASI to transport goods along the same routes without the approval of Cewal.⁷³

The Commission found that the liner conference shipping companies had infringed article 81 by sharing trade in the network of routes that they operated through express agreements prohibiting members of the different conferences to enter the market of the others and forcing syndication to either of them.⁷⁴

The violation of article 81 was instrumental to the commission of an abuse of collective dominant position under article 82.

The conference members collectively (90% shares) had agreed to implement the Ogefrem contract, drawn up loyalty bonds and had met and undercut freight rates of GC in ships sailing on the same or similar dates suffering considerable losses, with an aim was to eliminate the only competitor.⁷⁵

⁶⁹ ¶ 140, 146

⁷⁰ ¶ 140

⁷¹ ¶ 163

⁷² T-24/93 and C-395/96

⁷³ ¶ 11

⁷⁴ ¶ 12-14

⁷⁵ ¶ 15

The CFI considered that “the close relations between shipping companies within a liner conference enable them to implement...practices that constitute unilateral conduct susceptible of infringing article 82”⁷⁶ and observed that Cewal’s conduct “reveals an intention to react unilaterally to a threat... and (was a part) of an overall strategy”⁷⁷.

The Commission differentiated between PP and the fighting ships practices in question, as it is recalled by CFI. The reprehensible conduct consisted in scheduling Cewal’s vessels on dates similar to GC, jointly fixing fighting rates different from the normal ones equating or beating or GC’s advertised prices; and experiencing losses of earnings borne by the conference members.⁷⁸

“These jointly fixed rates were different from the rates normally charged by (the conference) and were determined not according to economic criteria (i.e. on the basis of costs) but solely in order for them to be the same or lower than the prices advertised by (the rival) with the shortfall in revenues resulting from application of this price-fixing system rather than the conference tariff being borne by all conference members”⁷⁹

The CFI said that “the fact that the result sought (eliminating a competitor) is not achieved is not enough to avoid the practice being characterized as an abuse of a dominant position”⁸⁰, which reiterates the Court’s jurisprudence on the issue: in essence it is only required that the abuse may have a certain undesirable effect.

Besides, the CFI, established that the conduct could not be disqualified as abusive despite GC’s shares increasing because its shares “might have increased more significantly”. This differs with Akzo and Brooke, where the limited impact of the conduct was taken into account to reduce the fine and the USC rejected to speculate whether the generic tobacco industry would have increased furthermore had not there been a price war, respectively.

The Court of justice upheld all of the findings given by the CFI except for the fines that were annulled on grounds that they violated the procedural rights of the applicants insofar as the Commission identified the collective entity Cewal as the infringer but decided to punish its individual members without notifying them at the stage of “statement of objections”⁸¹

The ECJ said that the dominant position of the liner conference made it unattractive for a user of the services, i.e. the cargo owner or a buyer in Holland, to “resort to an independent competitor unless it was able to offer lower prices”.⁸²

Therefore, the reasoning is that the only way there could be effective competition on a concentrated market is if rivals can beat the prices of the dominant firm.

The Court stated that the only means of competition open to a rival firm is its capacity to offer lower prices than a dominant company.

⁷⁶ ¶ 64

⁷⁷ ¶ 65

⁷⁸ ¶ 139

⁷⁹ ¶ 101

⁸⁰ ¶ 149

⁸¹ ¶ 142

⁸² ¶ 116

Cewal's interest in matching those prices is for the double purpose of eliminating its only competitor (as it admitted in a hearing) and to maintain higher prices to users for services that do not face competition.⁸³

A systematic interpretation of paragraphs 118 and 119 of the judgement allows us to conclude that according to the ECJ a dominant company that has market shares in excess of 80% cannot adduce the meeting competition defence to justify lowering its prices and sustaining losses.

“It is not necessary to rule on the circumstances in which a liner conference may legitimately adopt lower prices to compete with a competitor ... It is sufficient to recall that the conduct at issue is that of a conference having a share of over 90% of the market in question and only one competitor.”

The interesting points of this case are two: 1- Prices above average costs can be considered predatory if they deliberately lead to loss of revenues.

2-ECJ considers plausible a collective abuse of dominance, contrary to the American cases.

These two judgements summarising the European case law nevertheless comprise two traditional industries: chemical products and shipping services. There is a consensus amongst economists that the Akzo cost rules cannot be applied to the telecommunications.⁸⁴ However, in *Maritime Belge*, the Commission did not use any cost threshold since the case involved several infringements.

It seems as if the ratio was that non-profit maximising prices that cause injury, even if above costs can be predatory. Can we draw an analogy applicable to the telecommunications sector? An answer would have to analyse whether matching competitors' offers with prices that reduce revenues is predatory in a single dominance scenario. Additionally, it would require to examine whether a company is present in several sectors since incentives to predate are weaker in a single product market than in a multi-product one.

The case law above evidences that it is not fully clear what cost thresholds are suitable to different types of industry because the Court found appropriate the Commission's choice in *casus*, but we ignore whether it would reach the same conclusion in a different case. Do we need more guidelines and specific rules to handle telecommunications complaints?

II.2.4 Defences under US and EU law

Dominant companies are not precluded from competing on the merits whether it causes harm to competitors since the basis of competition law is to protect competition and not competitors. A *prima facie* abusive behaviour can be explained by logical, verifiable, consumer-friendly and proportional reasons.⁸⁵ Important theorists like Friedrich von Hayek have expressed opinions in

⁸³ ¶ 117 and 119

⁸⁴ Discussed below

⁸⁵ Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (2004/C 31/03), paragraphs 77-88

that sense.⁸⁶ Others have responded that the purpose “loses its meaning where the only competition available is constituted by one competitor”.⁸⁷

In USA, the Rob-Pat Act deals with this issue in article 13 a) and b). The provision provides a limited list of defences and the defendant has the onus of proving that there is no intent or knowledge contrary to findings of abusive behaviour in a prima-facie case made against them.

The possible excuses are:

(i) Differences in costs of manufacture, sale and delivery of the goods.

This justification is not applicable, however, to quantities over some volume thresholds established by the regulator (FTC), because there are few wholesalers in the market

(ii) Matching competitors’ prices: “conduct undertaken in good faith to meet an equally low price of a competitor”.

(iii) Selection of customers in bona fide transactions and not in restraint of trade.

(iv) A change in the market situation: “changing conditions affecting the market for or the marketability of the goods concerned”.

This last provision contains an enumeration of changes which seems to be descriptive and not exhaustive given the wording chosen: “actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process (auction sales in Europe), sales in good faith in discontinuance of business in the goods concerned”

In Europe, the Commission applies a twofold test: a soft test where the case handler asks if the efficiencies outweigh the harm to competition and a strict test where a dominant firm has to prove that the restrictions were imperative to the running of the business, that is, prove that its behaviour is a prerequisite to compete on the merits and therefore competitive.

DP names three types of defences: objective necessity, meeting competition and efficiency.

1- The conduct is owed to objective externalities uncontrolled by the dominant company and it is indispensable for the production or distribution of the goods. For instance, because of safety reasons related to the dangerous nature of the good. The dominant company cannot however adduce this excuse to eliminate competitors’ products that it regards dangerous or inferior.⁸⁸

2- It is only applicable to individual and not collective behaviour, i.e. cartels. The Commission applies a proportionality test which contains four cumulative conditions: the conduct has to be suitable to achieve the aim of competing with cheaper rivals, indispensable mean, i.e. the only possible alternative to achieve the aim, limited in time and finally, meet a balance between the company’s interest and the purpose of competition as a whole.

This defence is not possible if evidence is found about the intent to exclude or if low prices to match competitors’ are coupled with, for example, increase in capacity.

⁸⁶ Hayek (1978). “Competition as a discovery procedure”, in *New Studies in Philosophy*,..., Chicago ¶ 179-90

⁸⁷ Per McGehan J. in *Commerce Commission v. Fletcher Challenge Ltd* (1989)

⁸⁸ T 30/89 *Hilti AG v Commission* CFI (1991), at 118

More importantly, in PP, the Commission says that as a general principle when the company prices at below AAC the defence is not pertinent and in the case of prices above AAC but below ATC, the ground is only admitted if all of the conditions above are met which is usually unlikely, according to the Commission.⁸⁹

This is noticeable because Com⁹⁰ contradicts itself in paragraph 128 where it says that prices below AAC can be justified though the ground is “unlikely” to succeed, instead of the “not applicable” expression used earlier. Prices below AAC could, accordingly, be invoked in case of re-start up costs, strong learning effects or investments made “in temporarily lower prices may for instance be required to enter a market or to make more customers familiar with the product”, such as during promotions.⁹¹

In p. 129 Com refers to the “change in market conditions” clause included in American law but reiterates that a reason like minimising short run losses due to entry of a more efficient rival is not applicable with prices below AAC.

3- There are 4 cumulative requirements: -proof of efficiency realised or to be realised,- indispensability of conduct, -benefit to consumers, and competition regarding a “substantial” part of products is not eliminated.

DP considers as efficiencies improvements in production or distribution, including quality or reductions of specific costs and economic-technical progress. Additionally, protection of client-specific investments is allowed. The same conditions as in 2 are required. The consumers requirement would fall when the efficiencies are to be realised lately in the future.

If the company’s market shares are proximate to monopoly (75%) or the demand in the market is inelastic, this defence cannot be adduced. A company with monopoly power cannot argue any efficiency claim because it would not respect the balance of interests referred to earlier. This efficiency is not applicable either in predatory pricing cases.

III. Telecommunications: Economy and Law

III.1 An economic approach to PP rules on the telecommunications industry

A better understanding of the treatment of PP under European telecom package rules requires an insight into the economical background underlying it.

There are many types of cost definitions and the choice is essential to the antitrust authorities who investigate alleged violations. Where one cost-threshold would lead to predatory pricing, another measure can lead to competition on the merits.

⁸⁹ ¶ 80, 129

⁹⁰ European Commission

⁹¹ ¶ 108

Costs can be fixed (FC) or variable (VC) with respect to the quantity of output. The costs of all production processes exhibit both some fixity and some variability over certain levels of production and during a period of time.⁹² A cost is variable if it changes with the level of output (production) and fixed on the contrary.

An avoidable cost (AC) is one that can be “avoided”. For example, in the airline industry, energy costs in a route are variable since they depend on international fuel prices but they are not avoidable.

Marginal Cost (MC) is the cost of producing one additional unit of output, i.e. in a brew factory, the expenses of producing one litre extra of beer.

The incremental cost (IC) of a product is the additional cost of producing the product above the cost of producing all the remaining. Related to IC is the concept of stand alone costs (LC). The stand alone cost of any product is the cost of manufacturing that product excluding the other provided by the enterprise. The LC usually includes administrative costs such as overheads.

Telecommunication industries are characterised by the high level of FC that derive from access (connection) charges in national and international calls. VC depend on the volume of traffic on the network which include expenditures to provide connection, operate switches and carry signals, as well as billing and collection of expenses.

The pricing policy of firm that only produces a single product with no FC is simple. A profit maximising company would choose a price where the marginal revenue (MR) equals its MC.

Start up companies may nonetheless operate with higher costs above the ATC and dominant companies can in some cases also have costs below ATC but above AVC.

Pricing below costs is presumed predatory. However there are cases where companies suffer a low demand curve which forces them to price below ATC in expectance of future gains.

There are special situations where, for instance, a company will charge above cost-efficiency prices when it has invested a lot in a new product or will price below cost if a rival has developed new technology that makes its products obsolete.

Most undertakings nowadays produce many products at the same time.

A recurrent question in economics⁹³ is how to allocate common costs amongst all those products, which usually is made in proportion to the contribution of a particular product’s output to total revenue. This means that the price for a single product must be above its AVC plus a part of the common costs. This is called the fully distributed cost method (FDC).

⁹² Phedon Nicolaides and Roel Polmans, Competition in EC Telecommunications, Cross-Subsidisation, Access and Predatory Pricing.

⁹³ Nicolaides. Heald. Young

Sometimes it is not sufficient to allocate variable costs to the price of one single product, because it has to bear common and fixed costs. Then we use incremental costs, which include product-specific costs that are fixed, variable and sunk: $P \geq AIC$.

Economists think that the latter formula is the best option to measure the costs in the telecommunications.

III.1.1 Pricing of intermediate inputs or access pricing and margin squeeze

Telecommunications and software are the fastest growing industries today. We are experiencing the convergence of network industries through telecommunications, computers and television that are the backbone of today's economies.

Networks are composed of complementary components. They are created by combining separate elements demanded by users and often provide necessities. Production of individual elements exhibit characters of scale and so their supply tends to be monopolized.

Unless a single firm provides all the elements, disjoint networks must interconnect to ensure users a full range of services. Interconnection increases the variety of services to choose from. According to Economides "network industries exhibit increasing returns to scale in production and incremental cost is often negligible".⁹⁴

In the telecoms, network effects appear because of complementarities. Users value more a telephone subscription to a large network than a smaller, i.e. Windows Msn only allows instant messaging through the Internet with users within the same net. It is more valuable for me as a user to subscribe to a net with more people because there are better communication chances.

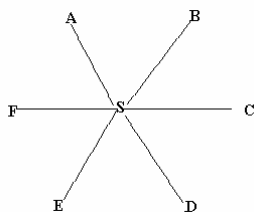


Figure 1: A star network

In the figure above, customers A, B,...F are connected to a switch (S). Although the goods "access to the switch" AS, BS,...FS have the same classification and are considered as substitutes, they are in practice used as complements. In particular, when customer A makes a phone call to customer B he uses both AS and BS.

Network externalities arise because larger sales of components of type A induce larger availability of complementary components B_1, \dots, B_n , thereby increasing the value of components of type A. Authors have described competition in network economies as Schumpeterian rivalry⁹⁵

⁹⁴ See Nicholas Economides at Competition Policy in Network Industries: An Introduction

⁹⁵ Austrian economist Joseph Schumpeter, known for his theory of business cycles and development. It is argued that the European Union follows Schumpeter's learnings in their Lisbon Strategy.

denoted by a succession of “temporary monopolists” who displace one another through innovation.

The question of how a monopolist owner of a bottleneck facility should set the price for access to the facility by an entrant or rival supplier of a complementary component (access pricing) is one of the basic tasks of NRAs across Europe.⁹⁶

Traditionally, regulators have fixed access pricing (P_a) on the basis of the marginal cost of the network service, i.e. $P_a = MC_n$. This has been criticized because it does not look upon the “opportunity costs”, i.e. foregone revenues incurred by a company obliged to give access.

To solve this some theorists⁹⁷ have agreed on the suitability of the application of the so-called “efficient component pricing rule” (ECPR). The ECPR states that the appropriate access charge by the bottleneck monopolist to the suppliers (actual or potential) of a service, which he also produces is a fee equal to his opportunity costs of providing the access plus any foregone revenues from a reduction in his sales of the service and deducting the savings stemming from avoided costs. Mathematically, the rule would be expressed as $P_a = AIC_n$ (share of the incremental costs of network) + ASC_s (sunk costs of service) + P_u (amount of profit per unit)

The main critics posed against the rule are that it compensates the incumbent’s network costs and lost profit, even though it should not. That is why others prefer to simplify the equation to $P_a = AIC_n + ASC_s$. The expression would cover the firm’s incremental costs of providing access and the sunk costs gone on that service, if there are any.

We would rather see the equation reduced even more and say $P_a = AIC_n$, because we feel that competitors should not have to reward the dominant company by paying its sunk costs, which are difficult to determine and have in 100 per cent of the cases been financed by tax payers.

III.1.2 Margin Squeeze

A margin squeeze occurs when a dominant and vertically integrated operator charges prices for wholesale access which are so high that competitors are left with no margin (profits) because they are forced to increase their retail (input) prices, over and above the retail prices charged by the dominant firm for the same services.⁹⁸ The term squeeze best describes the asphyxiating grip felt by small firms when incumbent firms price their bottleneck facilities⁹⁹ access at similar levels as their charges to end-users.

Typical examples of “bottleneck” facilities are the former railway monopolies in the United States, that owned the tracks in many states, public telephone companies that controlled the

⁹⁶ National regulatory authority. See Need for more regulation?

⁹⁷ William J. Baumol and Gregory Sidak *Toward Competition in Local Telephony* (1994); William J. Baumol & Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, YALE J. REG. 171 (1994)

⁹⁸ A wider definition is given below under Deutsche Telekom

⁹⁹ That are required to provide a service

public switch and the network or today, software companies like Microsoft, that have a patent on the source code of their products.¹⁰⁰

NRAs have developed price-squeeze tests characterised as violations of regulations on access and interconnection pricing that are applicable to companies who possess an essential facility, such as incumbent telephone consortiums. The regulatory authority can calculate whether a certain retail price is below or above the cost covering level, without a thorough inquiry because access to essential facilities is determined by ex ante rules.

Additionally, the Commission's notice on the competition applicable to access agreements says in paragraph 97 that excessive pricing for access may amount to refusal to grant access and in p.117 it includes an additional prize squeeze situation when a vertically integrated dominant company, charging too high access prices to wholesalers or competitors through its upstream branch cannot reap profits itself in the downstream or retail segment based on those same prices¹⁰¹. This could happen when it deliberately allocates costs to access operations that correspond to retail or wrongly determines the transfer prices.¹⁰²

III.1.3 Input Pricing

Input pricing has a direct correlation with predatory pricing since PP relates to final products destined to consumers in the downstream market. Normally, when a multi-product firm produces several items, the one found to bear a predatory price is also subject to cross-subsidisation. Economists agree on the use of AIC test to allocate costs of inputs instead of marginal cost, which can lead to a misallocation of resources for two reasons:

1- In economies of scale, where the cost curve decreases with an increase in input production, a price equal to the marginal cost does not cover all the costs.

2- In the opposite situation, i.e. when the cost curve increases with an augmentation in the number of outputs, this leads to marginal costs being higher than average costs. Under these circumstances when the price is equal to marginal cost, the company would be earning super profits.

In traditional industry, the price should reflect the AC in single-product firms and the IC, which includes product-specific costs (variable, fixed and sunk) in multi-product firms.

DP deals with pricing in telecoms in paragraphs 122 and 123. The benchmark preferred is LAIC because the industry has recognised network effects. They state that prices below LAIC are presumed predatory in cases concerning activities protected by legal monopoly such as the postal

¹⁰⁰ In Europe Microsoft has been forced to allow interconnection to their platform. See the press release IP/04/382 on the EC Competition site and <http://www.europa.eu.int/comm/competition/antitrust/cases/decisions/37792/en.pdf>.

¹⁰¹ Commission Decision 88/518/EEC of 18 July 1988, Napier Brown/British Sugar (OJ L 284, 19.10.1988, p. 41): the margin between industrial and retail prices was reduced to the point where the wholesale purchaser with packaging operations as efficient as those of the wholesale supplier could not profitably serve the retail market.

¹⁰² Cost of products used internally

sector in many countries. Normally there will be a component of cross-subsidisation in multiple markets where the dominant leverages its power into the free competitive market. Predation will be presumed even if a company is not dominant on an adjacent market as long as it is in the one related in which it holds its power.

Prices below LAIC in sectors recently liberalised are predatory according to DP. The aim is to avoid that such pricing undermines that liberalisation process.

The competition notice mentioned above admits in paragraph 110 that the Akzo test is difficult to apply in network industries because variable costs are very low and fixed costs are high and states that the correct test is to compare prices with long run incremental costs over a reasonable period of time (not too short nor long).

The LAIC cost rule used in telecoms is difficult to determine given the uncertainty connected to any long run cost predictions and it may unfairly benefit an infringer.¹⁰³ But, which costs are suitable for the industry?

From an economic perspective, it is widely accepted that in telecoms AIC should be the common price floor due to the existence of scale and scope barriers. Our pick would be to establish that during the first X months of entry by an inefficient competitor, the incumbent will have to price above the rival's average variable costs, and afterwards, above or at the same level as its own AIC. The period of months will depend on the growth of the rival and the level of output.

Price-squeeze is one of the possible effects of excessive pricing of access to a telecommunications network or underselling of final input services. Therefore it tends to be confused with predatory pricing tests. Investigators would take intermediate or access prices in margin squeeze tests while they would use input prices to assess predatory pricing complaints. The difference being minimal and the results are often the same.

NRAs prefer margin squeeze tests because they are more easily identifiable in the context of a regulated telecommunication market with predetermined access prices and less time consuming than a predatory pricing investigation. The subjacent query is double: When do we apply a margin squeeze or a predatory price test and what rules do we apply: sector specific or article 82? Besides, in many European countries control of competition in the telecommunications is split into two authorities and this may lead to coordination problems.

III.2 A legal approach to PP rules on the telecommunications industry

III.2.1 The 2002 telecommunications package

¹⁰³ See Mappy below.

The EU special rules on telecoms define pricing rules because there is concern that incumbent firms will charge either very low prices or very high access prices to prevent new competitors from entering the market.

The EC telecoms package, recently reformed, has clear pricing rules focused on regulating the information on costs provided by incumbent companies. First, we discuss the recommendation that originated the package and then the regulations and directives in a hierarchic order.

III.2.1.1 Interconnection Recommendation ¹⁰⁴

In a 1997 recommendation prior to the approval of the access directive¹⁰⁵, the European Commission already identified the main issues of the sector and proposed solutions: “For new entrants seeking to compete with the incumbent operators for the provision of telephone services, interconnection to the existing public switched telecommunications networks is essential. The bottleneck nature of the incumbent's fixed network, has had for effect the imposition of obligations such as cost-orientation of the interconnection price and accounting separation”.

The Commission’s approach to interconnection pricing is based on an analysis of the costs (sunk, recurrent and increasing) borne by the network. It distinguishes between an ideal situation with a “level playing field” and stable market shares and the reality of a newly liberalised market. Under the first one, the best interconnection price would be based on capacity and in the second case; on traffic charges.

The old Interconnection Directive also preferred as a pricing reference “charges based on a price level closely linked to the **long-run incremental cost** (LRAIC) for providing access to interconnection”¹⁰⁶, because it “can be used to obtain an estimate of the cost that would be found in a fully competitive market”. The directive mentioned, subsidiarily, a number of cost standards that could be used by companies to base their interconnection prices such as “fully distributed costs, marginal costs, stand-alone costs”¹⁰⁷. It would have been easier if the measures had been narrowed to one.

The LRAIC proposal contained in the 97 Directive is still valid since the 2002 Directive¹⁰⁸ has “carried over and maintained” the obligations imposed in article 7 therein, which makes reference to the list of cost measures.¹⁰⁹ There is however a positive shift towards using current costs that are closer to AIC, in the 2005 recommendation.¹¹⁰

The recommendation also proposes¹¹¹ that all “incremental interconnection costs... be divided up in a fair and transparent manner between the (incumbent) and those interconnecting, with the result that the cost

¹⁰⁴ Recommendation 98/195 of 8 January 1998, as last amended by Rec. 2002/175/EC

¹⁰⁵ <http://europa.eu.int/ISPO/infosoc/telecompolicy/en/r3148-en.htm>

¹⁰⁶ Directive 97/33/EC on interconnection, recital 10

¹⁰⁷ Annex V

¹⁰⁸ See Access Directive below

¹⁰⁹ Recitals 12 and 14 and article 7 of the Access and Interconnection Directive.

¹¹⁰ See below

¹¹¹ 3.3, ¶ 5, in fine

of interconnection to any party is the LRAIC". The proposed measure would look like this mathematically, $P_a = \text{LRAIC}/n$, where n is the number of companies that have to pay the costs.

Finally, part II of the recommendation proposes the adoption of cost accounting systems by incumbent operators, explaining the allocation of all of their costs in their financial reports.¹¹²

In practice, the LRAIC rule tends to benefit competitors since the measure excludes costs that are potentially avoidable in the future. In the telecoms, many of the costs are avoidable due to technological improvements that reduce costs.

For instance, Mappy has AIC of 8 euros per unit, and it spends half of its proceeds in R&D. Its variable costs vary an average of 30% over a 2-year period due to cost-reductions. The LRAIC is calculated at 5,6 euros. Bunny, complains that Mappy is charging them 9 euros for access and at the same time 12 euros to final users. Bunny says that it has marketing, legal and running costs of 3 euros and alleges that the input price charged by Mappy equals its costs, leaving them with no margin. Besides, despite Bunny's attempts to attract Mappy's customers with attractive offers, after several months they have only managed to build a customer base of 200 homes, compared to the 200.000 served by Mappy. Bunny, threatened by bankruptcy is considering pulling out. Mappy's cost curve is shown in the annex.

The NRA, resorting to the LRAIC test, estimates that Mappy's long term AIC is 6,8 euros and will revise them after 2008. The NRA concludes in its findings that Mappy's final prices are not predatory but that its access charges should be lowered 2 euros to allow a certain margin. Bunny, who has been on the business for a bit over a year makes a risk assessment and decides to pull out.

Clearly, the option of the LRAIC test is unfair in this case. Had the NRA used the AIC of Mappy during the time of the alleged unfair practices, i.e. the year 2006 in this case, the authority would have reached a finding of predatory pricing.

The LRAIC is not a suitable benchmark because of the arbitrariness of assessing costs as fixed or variable. In addition, AVC in the telecoms tend to decrease as technology becomes more sophisticated.

However, the recommendation on interconnection costs¹¹³ says that the FLLRAIC is intended to reflect "current costs rather than historic costs". Perhaps the purpose is to use actual costs but if the intention is such, should it not be better to conceive a formula that does not mean future costs? The latest Recommendation on accounting separation supports this view.

III.2.1.2 Recommendation 2005

¹¹² C(1998) 960 final

¹¹³ CE Recommendation of 8 April 1998, part 2. It can be downloaded at http://europa.eu.int/information_society/policy/ecommm/doc/info_centre/recomm_guidelines/interconnection_recommendation/c98160en.doc

The Commission latest Recommendation updating the previous has taken a significant step forward despite withholding some of the vague legal formulation of its predecessor. It prompts the use of current cost accounting system (CCA), meant to reflect current costs and is much closer to the AIC measure that economists advocate.

Recital 8 refers to the LRAIC cost measure, specifying that the “forward-looking approach (such as long run incremental cost) is based not on historic costs but on current costs”. The LRAIC would reflect the current costs of assets, as they are revalued thanks to modern technology. This statement is however double-edged because from one side you may reduce costs in the future with improved technology and on the other hand, costs augment due to extra investments. The term long run referred to is still confusing in our opinion when the aim is to consider actual running costs.

The Recommendation is designed to provide some flexibility when analysing current costs and therefore recital 7 talks about a “corrective action”, which may include “spreading any price adjustment over a reasonable period of time”. The Commission actually used this approach in the Wanadoo case discussed below to adjust costs to the reality of the moment, which often favours defendants. In the same sense, recital 9 of the instrument suggests an adjustment of costs to take account of the real value of the network assets, i.e. the local loop, wherever a firm chooses the CCA system.

The Recommendation gives an indication in number 3 of what it means by CCA, i.e. an evaluation of the network value “estimating the costs faced by equivalent operators if the market were vigorously competitive”, which requires an appraisal of current assets in comparison to the value they would have had if they had been modern and there were competitors. Such exercise may be complemented by the LRAIC methodology.

The CCA is used to inform pricing decisions, i.e. it can be a very useful instrument when a predatory pricing case arises.

The whole purpose of the recommendation is to avoid anti-competitive behaviour, “notably margin squeezes”¹¹⁴, and “unfair cross-subsidy”¹¹⁵. The link between the two with predatory pricing has been established before and it is further reinforced when we recall that the basic principle that permeate the Recommendation, i.e. cost flexibility, has been applied by the Commission in the Wanadoo decision, which is a fundamental predatory pricing case in the telecommunications.

III.2.1.3 Regulation on Local Loop Unbundling ¹¹⁶

The regulation on local loop¹¹⁷ (LLPR) states that access prices should be “transparent, non-discriminatory and objective” to ensure fairness and cost recovery of the service.

The regulation talks about ensuring that the local loop provider “covers its costs plus a reasonable return”.¹¹⁸ The LLPR establishes that access prices have to be profitable.

¹¹⁴ Recital 6

¹¹⁵ Number 1 and 5

¹¹⁶ Regulation 2887/2000/EC on unbundled access to the local loop

¹¹⁷ Regulation 2887/2000 on unbundled access to the local loop

¹¹⁸ Recital 11

The LLPR specifically emphasizes on the importance of prices being at competitive levels to ensure “that there is no distortion of competition, in particular no margin squeeze between prices of wholesale and retail services”. Logically, if access prices have to be profitable, the same imperative applies to input prices, that necessarily have to be higher than the former.

The similarities between the margin squeeze and predatory pricing tests discussed earlier allow an extension of the scope of the regulation, by analogy, to predatory cases. We feel that the obligations included therein are an effective method of preventing predatory pricing in the telecoms.

III.2.1.4 Framework Directive ¹¹⁹

The framework directive, in article 13, requires companies to maintain separate accounting books to better identify “all elements of cost and revenue” and explain how they allocate costs, following the principle of cost-causation (ABC) amongst the different services, “including an itemised breakdown of fixed asset and structural costs”.

In practice, this obligation is only applicable to companies with market power since letter b exempts NRAs from requiring firms with less than 50 million euros of annual revenues in the sector, to comply with the rule.

The obligation is also a valuable mean to prevent predatory pricing, since it eliminates the information asymmetry component that characterises predatory behaviour, i.e. where competitors know what costs the dominant company has.

III.2.1.5 Access Directive ¹²⁰

The new Access and Interconnection Directive lays down specific duties on operators with dominant position. Articles 9, 11 and 13, impose obligations of “transparency” and “non discrimination” through accounting separation and cost orientation prices, which are aimed at regulating prices in markets that are not fully competitive yet.¹²¹

Recital 20 specifically refers to the issues of margin squeeze and excessive pricing and lays down obligations divided into *light* and *heavy*, depending on the level of competition in the area affected. Hence, reasonable prices for carrier selection is a mild duty and cost-orientation is a greater burden, addressing the problem of supra competitive prices.

Recital 20 and its corollary article 13 define and establish a broad rule for the calculation of prize squeeze: “Operators with significant market power should avoid a *price squeeze* whereby the difference between their retail prices and the interconnection prices charged to competitors who provide similar retail services is not adequate to ensure sustainable competition”.

¹¹⁹ Directive 2002/21/EC on a common regulatory framework

¹²⁰ Directive 2002/19/EC on access and interconnection

¹²¹ Recital 18 of Access Directive: “Accounting separation allows internal price transfers to be rendered visible, and allows NRAs to check compliance with obligations for non-discrimination”.

The Directive goes on saying that in the calculation of costs for purposes of prize squeeze finding, NRAs have to “allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations.”¹²²

The passage means that authorities shall take account of adjusted fixed and sunk (building and labour) and variable costs (investments, service-specific costs-capital) to determine the existence of malpractices. Furthermore, the method used for the calculus will be shaped by the specific circumstances of the case: “the method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits”.

Article 13 gives form to the set of purposes included in the recitals and establishes that NRAs can “impose obligations relating to cost recovery and price controls, including obligations for cost orientation of prices and obligations concerning cost accounting systems, for the provision of specific types of interconnection and/or access, in situations where a market analysis indicates that a lack of effective competition means that the operator concerned might sustain prices at an excessively high level, or apply a price squeeze, to the detriment of end-users”.

When we break down the paragraph above for analysis we can distinguish several elements:

1- The first one is that regulators can only intervene ex ante when there is “lack of effective competition”, which in conjunction with article 8 of the same directive and 16 of the framework directive can only mean that the market is characterized by the presence of one or more companies with “significant market power” or dominance.

Thus, the first condition to regulate prices in the telecom sector is that there is a dominant player in the relevant market.

2- The second element is that regulators can intervene ex post when a dominant operator “sustains prices at excessively high or low levels”.

3- The third element is that there has to be an injury to the final consumers.

The measures available for the public authority are the policing of prices that must be cost-oriented, to ensure that they reflect real costs. The duty of keeping a cost accounting system is also a mean to control the correlation between prices and costs.

Article 13 (2) in fine, reads that NRAs “**may also take account of prices available in comparable competitive markets**”. This predicate would permit NRAs to compare prices in similar markets to find out if players in a non-competitive market are abusing their power to fix prices as they please, irrespective of demand.

Lastly, the Directive has laid the burden of proof of having competitive prices on the operator: the operator has to prove that “charges are derived from costs including a reasonable rate of return on investment”.

¹²² Recital 20 and article 13, p.1

The central principle pursued with this new set of directives is the interoperability of the electronic services at a non-discriminatory basis. The way to achieve it is to have transparent prices both in the upstream and downstream market, to prevent cross-subsidisation of services.¹²³

The provisions of this directive are also a cogent means to put off predatory pricing.

III.2.1.6 Universal Service Directive ¹²⁴

The Universal Service Directive wraps up most of the concerns raised by antitrust proceedings in the context of article 82, such as the necessity of having non-discrimination obligations, as well as setting a ban on product-tying and monopolistic pricing (excessive and predatory).¹²⁵

Article 17 on regulatory controls on retail services specifically identifies predatory pricing as a possible effect present in non-competitive markets.

The provision's applicability is subject to two cumulative conditions: a) the existence of a dominant company in the downstream segment of a telecom industry and b) when the "carrier selection and carrier pre-selection" obligations, i.e. dialling a carrier selection code to call ¹²⁶ or the duties included in the access directive, i.e. non-discrimination, accounting-separation, cost-orientation, give access, are not sufficient to tackle the abuse.

Hence, NRAs can impose "requirements that (a dominant company) does not ... inhibit market entry or restrict competition by setting predatory prices", on the basis of the principles of proportionality and insofar as they enhance consumer welfare. ¹²⁷ In particular NRAs are empowered to apply "retail price cap measures, measures to control individual tariffs, or measures to orient tariffs towards costs or prices on comparable markets, in order to protect end-user interests whilst promoting effective competition".

The overall principle informing the telecommunications package in Europe is that prices have to correspond to the laws of supply and demand in basic economics. In sum, prices have to be "natural" and not "artificial".

Our point is that predatory pricing does not find all its substantive law in the jurisprudence of the ECJ or article 82, but is inherent in the principles that inform the directives and regulations that govern the European information society. The telecom package complements sweetly article 82. In fact, a responsible application of the obligations of the directives ex ante would make ex post control superfluous and predation very rare.

III.2.2 Commission Decisions in Telecoms

¹²³ See articles 9, 11 and recital 16

¹²⁴ Directive 2002/22/EC on universal service

¹²⁵ See recital 26 and articles 3 (2) and 17 (2) of Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services

¹²⁶ Article 19 of the Directive.

¹²⁷ Article 8 of the Framework Directive

III.2.2.1 Deutsche Telekom ¹²⁸

This decision, regarding Deutsche Telekom's pricing strategy for local access to the fixed telephony network, was the first involving a telecommunications company since the sector was liberalised in 1998.¹²⁹ It was appealed to the Court of First Instance on the 30th July 2003. Some of the grounds of appeal include a contestation of the method used by the Commission in the calculation of the margin squeeze.

Deutsche Telekom (DT), the old incumbent holds virtually monopoly power in Germany and is present both in the downstream and upstream segments of telephony offering intermediate access to other companies (wholesalers) who did not have their own network.

The Commission found that DT was engaging in a margin squeeze by charging newcomers higher fees for wholesale access to the local loop (circuit between user and the public telephony switch) than what subscribers (final users) had to pay for retail lines. The conduct amounted to an abuse of dominant position prohibited by art. 82

“A margin squeeze can be found to exist if a vertically integrated operator charges prices for wholesale access which are so high that competitors are forced to charge their end-users prices that are higher than the ones claimed by the vertically integrated operator from its own end-users for similar services.”¹³⁰

“A margin squeeze exists if the charges to be paid for wholesale access, taking monthly charges and one-off charges together, are so expensive that competitors are forced to charge their end-users prices higher than the prices DT charges its own end-users for similar services”¹³¹

The mathematical test applied¹³² is as simple as “the difference between the retail prices charged by a dominant undertaking and the wholesale prices it charges its competitors for comparable services”¹³³ and it requires that “the wholesale and retail access services be comparable”.¹³⁴ If the calculation is negative then there is a finding of margin squeeze. By access it is understood the price payable to open a telephone line allowing people to communicate distantly. DT disputed the finding adducing that the access price was publicly regulated, that it did not have the freedom to vary it and that the appropriate test would be PP and not MS.¹³⁵

More specifically, the Commission concluded that during the period 1998-2001 DT charged competitors higher prices for unbundled access at wholesale level than it charged its own subscribers for access at the retail level. The price comparison was in itself evidence of MS without needing to analyse DT's costs.¹³⁶

¹²⁸ Case COMP/C-1/37.451, 37.578, 37.579- Deutsche Telekom AG

¹²⁹ Case 2003/707/EC-DT

¹³⁰ Napier Brown/British Sugar para. 66.

¹³¹ ¶102 of the decision

¹³² See note 33 above

¹³³ ¶107

¹³⁴ ¶109

¹³⁵ Margin Squeeze

¹³⁶ ¶ 153 of the decision.

Retail prices augmented from 2002 surpassing wholesale prices allowing a positive “spread” as the Commission called it, but remained nonetheless too insignificant to permit newcomers compete with DT and was not enough to cover DT’s own product specific costs.¹³⁷ The Commission compared DT’s downstream costs with wholesale prices it charged to competitors and found out that the latter inevitably rendered losses.¹³⁸

Regarding DT’s allegations that prices were subject to ex ante regulation the Commission answered that it had a wide range of possibilities to avoid MS such as raising input prices (charges) for Analogue, ISDN and ADSL to regular customers, evidence of which were the retail price increases in 2002¹³⁹

DT had in particular the chance of increasing retail access prices, i.e. the price payable by the end-user for acquiring a new subscription or the monthly subscription fee and simultaneously reduce call charges (*interconnection price*), i.e. the price payable for transmitting a call from one point to another.¹⁴⁰

The Commission also explained in the decision that DT could have even reduced local call charges “gaining more scope for increases of the monthly and one-off (contracting of subscription) charges for analogue and ISDN connections”¹⁴¹

Furthermore DT did not put up charges for ADSL access, a sector where it had absolute discretion since it was not regulated.

III.2.2.2 Wanadoo¹⁴²

This is the only case in Europe involving a telecommunications company and it is related to an emerging market segment (Internet) that is on continuing development, where competition is stronger than elsewhere.

The market analysed was ADSL for residential customers or high-speed Internet access for private users.

Television cable networks are a substitutable product for ADSL but their expansion in France was limited at the time and no cable operator was in a position to roll out a national network comparable to France Télécom’s ADSL facilities.

The Commission investigated Wanadoo, a subsidiary of France Telecom with market shares in the vicinity of 80% in the segment, during a 19 month period, time which coincided with "a

¹³⁷ ¶ 160

¹³⁸ ¶ 140 *ibid.* See also Notice on the application of the competition rules to access agreements in the telecommunications sector, OJ C 265, 22.8.1998

¹³⁹ ¶ 163

¹⁴⁰ ¶ 164-166

¹⁴¹ ¶ 168

¹⁴² COMP/38.233 - Wanadoo Interactive

tremendous boom in the high-speed Internet access market in France" ¹⁴³ and when almost all of the ADSL lines in France were owned by the incumbent France Télécom participated in 56% by the French State.

In 1999 Wanadoo had obtained an annual income of 39 million euros. By contrast, in 2000, 2001, 2002 it registered negative operational results of €129, €156 and €51 million respectively. Later, figures show a clear recoupment in 2003 with positive results of €277 million and a stabilization of profits in 2004 with €257 million (historical).¹⁴⁴

The Commission, relying on the ECJ case law in Akzo and Tetra Pak cited earlier applied here the AVC and ATC tests ¹⁴⁵ adjusted to take account of the fact that Wanadoo's aim is to recover recurrent costs (network costs and production costs) to obtain a margin which over time will also cover the investments made on research and SGA. The Commission spread the latter costs and devalued them according to depreciation, favouring Wanadoo insofar as they reduced the level of costs.¹⁴⁶

The adjustment considers the logic that the purpose sought by the firm is to attain future returns and not just immediate revenues in a fast growing market. The firm's assets devalue themselves with time as technology becomes cheaper replacing obsolete equipment and reducing network costs.

"The Commission has spread the costs of acquiring customers over 48 months to reflect market conditions"¹⁴⁷ and discarded the turnover rates observed during the IP because they did not reflect appropriately the increase in market shares of the business with Internet access amounting to 23% and almost 30% of the total turnover of Wanadoo in 2000 and 2001.

In this sense, the Commission used an original formula to calculate whether new customers could "improve net results" in the short term: $(X_{t-1} + x_t) \cdot m > a \cdot x_t$

" X_{t-1} " is the aggregate number of subscribers in month (t-1), " x_t " is the number of new subscribers in month t, " m " is the margin per subscriber, and " a " is the acquisition cost per new subscriber.¹⁴⁸

Wanadoo sold ADSL services at prices below AVC or ATC from the end of 1999 until October 2002, suffering substantial losses and at the same time its parent company, FT with monopoly power in the wholesale access segment (recoupment market) was anticipating large profits in the near future on its own wholesale ADSL products.

The pattern referred to earlier made the Commission feel that Wanadoo was intentionally predated with market shares going up by 30%.¹⁴⁹

¹⁴³ ¶ 4, Wanadoo decision . In less than two years subscribers went up from 200.000 to more than 1 million. 8,5 million customers in Europe at the end of December 2002 compared to 6 million in 2001

¹⁴⁴ The figures are taken from France Télécom site and differ from those given in the CE decision

¹⁴⁵ ¶ 81, 256

¹⁴⁶ ¶ 76

¹⁴⁷ ¶ 77

¹⁴⁸ ¶ 94

Competitors, who individually never held more than 10% of the market shares, had to sustain considerable losses to be able to compete and thus the pre-emptive effect of Wanadoo's PP strategy and the third rival even was put under bankruptcy administration.¹⁵⁰ In October 2002 Wanadoo ended this practice raising prices by 30% and consequently and the market continued its exuberant expansion.

Wanadoo justified its behaviour on several grounds such as the immaturity of the sector in question,¹⁵¹ economy of scale and learning effects but the Commission dismissed them because they did not meet the proportionality test. Other excuses were that it enhanced consumer welfare and lastly and it met competition.¹⁵²

The Wanadoo decision was bound to raise the debate surrounding the necessity of ex ante regulation of emerging markets such as the ADSL. Here the opinions of the Commission and the companies differ substantially since the former maintains that it is necessary to intervene on a market at a nascent stage.¹⁵³

The Commission pointed out that "nothing in Article 82 or in the case law provides for an exception to the application of the competition rules to sectors which are not yet fully mature or which are considered to be emerging markets" and stated that it was important for the authorities to could prevent abuses from happening.

IV. Modern times in jurisprudence

In 2002, in the Tetra Laval merger case the CFI said that "the possible recourse to such strategies (tied sales predatory pricing or loyalty rebates that are not objectively justified) cannot be presumed by the Commission"¹⁵⁴ This statement has to be interpreted in its context since PP was referred to as a possible anticompetitive effect of a merger, the main matter of the case.

In particular, the CFI said that when assessing ex ante how mergers can affect competition, the Commission is required to assess the likelihood of an abusive conduct taking place and disincentives that the company could consider to not breach antitrust rules.

"When the Commission...relies on foreseeable conduct which is likely to constitute abuse of a dominant position, it is required to assess whether ... the illegal nature of the conduct, the risk of detection, action taken by the competent authorities... and the financial penalties will make such a strategy unlikely".¹⁵⁵

This decision, embraces by analogy case law in the United States on recoupment insofar as it requires authorities to evaluate if the abuse could be possible before it takes a decision.

¹⁴⁹ ¶ 110

¹⁵⁰ ¶ 384 Mangoosta

¹⁵¹ ¶ 300-4

¹⁵² ¶ 306 et ss.

¹⁵³ as in n.137

¹⁵⁴ ¶ 218 Case T-5/02, Tetra Laval v. Commission

¹⁵⁵ ¶159 ibid

It is at least curious that the Court imposes on the Commission a subjective duty of reflecting upon how regulations act as a deterrent for companies to avoid unlawful practices. It is like asking a parole judge who studies the liberation of a convicted thief to examine the probability that he may commit further robberies in the future given the existence of laws protecting private property.

The ECJ later partially disagreed with the CFI's reasons but maintains the same lack of rationality as the former decision.

It said that the lower court had erred in law since that requirement “would run counter to the regulation’s purpose of preventing the anticompetitive effects of mergers”¹⁵⁶ and would make ex ante controls of concentrations useless but failed to pronounce whether presumptions of PP could be inferred.¹⁵⁷

On the contrary, in appeal the Court confirmed that the CFI “was right” in asking the Commission to assess the probability of the defendant in engaging in anticompetitive actions examining “the incentives to adopt such conduct and the factors liable to reduce, or eliminate, those incentives, including the possibility that the conduct is unlawful”¹⁵⁸ Besides, the ECJ determined that the Commission had the onus of providing ‘convincing evidence’ conducive to proving the likelihood of an unlawful behaviour resulting from a merger.¹⁵⁹

Thus, it appears, given the connection that the two Courts have established between the merger and the exclusionary practices such as PP resulting from it, that the Commission now has to assess the likelihood of PP materialising in the future when it conducts investigations of the kind, at least in ex ante investigations.

If the Commission also has to study the probability of allegedly illegal practices occurring ex post, when investigating complaints, it will mean that the Court has adopted the jurisprudence of its older brother in the United States. This is due to the fact that the Brooke decision may have been assimilated in the Court’s conclusions inasmuch as Brooke required a “reasonable possibility of harm to competition” and the European magistrates repeat that the Commission or complainants have to prove the probability that certain behaviour constitutes an abuse of dominant position.¹⁶⁰

In the recent General Electric Company decision¹⁶¹ (mergers) the CFI comes to similar conclusions as in Tetra Laval, not surprisingly since that judgment was used to form most of GE’s opinions. It reiterates the requirement that the Commission provide “convincing evidence” demonstrating that certain behaviour will produce anticompetitive effects, in the context of ex ante evaluations of agreements under antitrust laws.¹⁶²

¹⁵⁶ ¶75 C-12/03 P, Commission v Tetra Laval

¹⁵⁷ ¶59, idem note 75

¹⁵⁸ ¶74

¹⁵⁹ ¶71 and 72

¹⁶⁰ ¶159 as in note 73

¹⁶¹ note 44

¹⁶² ¶69 T-210/01

Furthermore, in subsequent paragraphs it recalls the absurdity stated by the ECJ that it was appropriate to consider the disincentives that companies might have when signing an agreement such as their propensity to respect the law.¹⁶³

It also says that the authority has the responsibility of assessing the likelihood that a conduct may have anticompetitive effects¹⁶⁴. If we interpret it analogically, we can also reach a finding that the authority has to assess the likelihood that predatory pricing (conduct) may have anticompetitive effects, providing “convincing evidence” conducive to such finding.¹⁶⁵

Another worrying trend observed in the Court is their pervasive tendency to substitute their own economic findings for those of the Commission¹⁶⁶, despite that the treaties forbid it.¹⁶⁷ The Commission has not appealed the judgement.

Concluding, the Court has established a link between ex ante control of potentially abusive conducts and actual abuses such as PP that require proof anticompetitive effect, similar to the recoupment test in the USA, meaning that a conduct will only be abusive and unlawful under article 82 TCE when evidence is given a posteriori demonstrating the injury caused to competition in the market.

V. Need for more regulation of the telecoms?

Rules in the EU concerning predatory conduct are based on article 82 of the EC Treaty. The phrasing of article 82 does not allow an inference of general rules applicable to predatory pricing and thus reliance upon the courts’ case law is mandatory with the added problem of the unpredictability of the judges’ interpretation of the provision.

How do we solve this dilemma in our field? There are two possibilities. The first one would be to supplement the existing case law with the comprehensive rules included in the regulations, directives, recommendations and guidelines that conform the telecommunications package. This option would mean that sector specific law would supplement and sometimes replace competition laws insofar as they are imprecise.

The second alternative is to produce a new piece of legislation, i.e. either a general regulation dealing with exclusionary behaviour in the context of article 82 applicable to all industries or a specific regulation only dealing with predatory pricing in any industry.

Antagonists would criticise this proposal because it introduces general rules that may not be applicable in special situations given the variety of existing methods, industries and costs. We believe that a general rule could be established accompanied by more flexible special provisions dealing with the reality and singularity of each case.

¹⁶³ ¶ 70-73 as n.87

¹⁶⁴ ¶ 74

¹⁶⁵ ¶ 296, economic literature and studies can be presented as evidence. See also ¶ 339, 340, 429, 433

¹⁶⁶ ¶ 124-280. See also ¶ 354, beginning phrase, ¶ 356, ¶ 407 onwards. See specially ¶ 456 (1) in fine, ¶ 459

¹⁶⁷ ¶ 90 Case T-109/01 and all the case law mentioned.

Professor Elhaug¹⁶⁸ says that the real question is whether regulating prices by dominant firms leads to more competition or not and he answers himself no. O'Donogue says that the imposition of restrictions on above-cost price cuts penalises efficient pricing behaviour when incumbents cannot restrict output because they sustain common costs by pricing differently high demand customers and low demand buyers, such as with airplane tickets.

He maintains that the effects of the restrictions are undesirable because they encourage entry by less inefficient companies that exit the market when the restrictions expire due to time lapse or loss of monopoly power. He claims as well that there is uncertainty as to when a company has entered a market making it thus difficult to assign a price limitation period, which could in some cases expire before a newcomer has even entered the market.

VI. A proposed rule

A more correct approach to the reality of predation in line with European case law would be in our opinion a modification of the Bolton, Brodley, Riordan rule. Investigations by antitrust authorities following reasonable complaints by competitors would be divided in the following steps:

- 1- A delimitation of the relevant market
- 2- An analysis of the competition conditions present in the relevant market and the actors involved, with particular examination of the existence of barriers to entry and exit
- 3- A determination of the market power of a company. If it is concluded that there is neither individual nor collective dominance, there is no need to go on.
- 4- If a company is dominant a further analysis of an allegedly violation of article 82 will involve:

A careful examination and comparison of the company's price and cost schemes provided by an independent and recognised auditor. The authority will be able to inquire on unclear aspects of the schemes, request additional accounts and elaborate its own schemes.

The prices and costs will be compared during the period of suspected predation that cannot be shorter than 6 months. In traditional industries, the cost measures considered will be AVC and ATC. In dynamic network industries those will be AIC (not long run) and ATC.

- a) If prices are below AVC or AIC depending on the industry, the company will be fined and forced to put up prices.
- b) When prices are above those measures but below ATC, the authority will be obliged to carry out a more extensive study of the market, investigating the dominant's economic plans by comparing its past and present behaviour and the likely injury it may cause to consumers.

¹⁶⁸ Einer Elhaug: "Why above cost price cuts are not predatory", EUI-RSCAS/EU Competition 2003/Proceedings

If the investigation considering prices above AVC but below ATC shows that there is predation because there is either an actual or likely injury to consumers and indications of the unlawful plan, the authority will be able to fine the company and require a price change. In both cases the investigation period will be the one covering the alleged unlawful prices including the time frame post opening of proceedings if predation continues.

At early stages of investigations, when preliminary analyses show symptoms of injury to consumers, the authority may require the company to immediately stop the conduct via interim measures.

In the evaluation of prices and costs, the authority will be encouraged to make comparisons between markets with similar characteristics and when the case requires it compare the pricing policy of a dominant company in markets other than the relevant one, as long as they have products or services similar to those subject to investigations. For example, if an investigation determines that the relevant market in an airline case is a route between cities x and y, when the prices there are unclear due to distortions, an authority will be able to take prices in route z-a insofar as it has a relation with the former.

5- There may be legitimate business reasons or defences that explain the allegedly infringing behaviour. When evidence shows that the abuse involves prices below AVC or AIC, the only defences possible will be the change in market conditions, i.e. to reduce costs in a downwards cycle by clearing stocks of obsolete or perishable goods and the promotion of new products. When prices are above those measures, all defences will be available.

The burden of proof for the first four points should rest with the plaintiff and the defendant has to provide the legitimate reasons.

An authority will not have to demonstrate the likelihood of recoupment when prices are below variable or incremental costs. It will have to prove that there is a probability of recoupment in cases of prices above the latter. The recoupment may happen in the market scrutinised or in adjacent ones.

The parties will be able to appeal any decisions to courts for revision and they will have right to access the authorities files and supersede all the operations used to reach a certain finding, provided that confidentiality is preserved. The parties will have a right to a fair hearing in order to express their views, protests and to respond to any accusation.

VII. Fighting predation

Some economists have proposed rules to counteract predation. Edlin, said that when an entrant charged twenty percent below the prevailing price, a monopolist could not respond with any price cut at all for twelve to eighteen months or until it lost its monopoly. Baumol¹⁶⁹, similarly suggested that a predator would have to be forced to maintain the price level during at least 18 months after a rival has left the market..

¹⁶⁹ “Quasi-permanence of price reductions”, Baumol, 89 Yale Law Journal, 1979

The father of economics Adam Smith may have already identified in his Wealth of Nations how to tackle predacious conduct in any given business.

In paragraph 3 of book 1, under the title division of labour, Smith preached the importance of the division of labour for the development of an industry and put as an example the trade of a pin maker where labour division multiplied the production of pins. His idea is fundamental to the notion of specialisation.

The word predation echoes in our minds nature's wild life. Darwin managed to rationalise two centuries ago how species evolve and explained the mechanisms that allow some species to survive while others perish.

In nature some animals give birth to many offspring of which only a handful survive and grow to be adults. They also tend to form flocks to better affront attacks by their predators as gnus do in the African plains. Similarly, in our societies, economic entities of weaker nature have greater chances of surviving a ferocious predator when they form a group and they are numerous. It is thus, their number and common understanding or joint behaviour against a rapacious behaviour that will allow them to stay in business.

Darwin demonstrated that species developed natural mechanisms to adapt to their environments, which they carried on to subsequent generations. Animals living in a habitat where catching preys requires certain abilities, develop natural hunting skills equipped with bigger claws or more speed. Those who did not adapt died. It is the natural selection. Likewise, in any industry those companies who do not specialise in an area or innovate are likely to disappear.

- **Specialisation of business:** one very specific market segment where the smaller company is strong or where the entrant wants to come in, following the division of labour logic. Necessarily, the monopoly will want to keep its hegemony in all segments and even if predatory pricing is present, the little rival, who specialises in producing just one or two services, can erode market power, maintain business and eventually succeed. The more companies dedicated to the production of one single service the more chances of survival and success they have. A little firm alone could barely resist more than a year if prices are normal. Under distorted competition conditions the same firm would not stand more than a few months. The more special the business is and the more companies entering the smaller the chances that the dominant undertaking can exclude or discipline them. If one is excluded then others could take over and eventually the losses incurred by the dominant would be so high that it would be forced to either raise prices or stop production.

Proof that this may occur can be found in for example a little market like Norway. The NRA has collected figures showing a 57% increase in revenues from an unregulated segment such as ADSL, with a dominant company like Telenor, a few important competitors and many small rivals, totalling 128 firms providing Internet services.

In the annexes to this thesis we show estimates of market shares of revenues of subscriptions and connections in the ADSL segment. The approximate figures show that the combination of small

firms increased revenues from subscription and connection in 2004 more than any of the other companies including Telenor.

- **Innovation:** As in nature, adaptation to the dynamics of telecoms requires innovation. Investments on research and development will pay off with a smaller but more special business giving better services than the dominant. The more independent companies investing a part of their revenues on innovation the more probable that they will find new technologies that revolutionise the market.

Proof that this is true in the telecoms industry is that innovation is the driving force of Internet and the source of revenues of companies such as Ebay, Google, Yahoo or P2P firms. An interesting example is Skype that has bouleversed fixed telephony with its voice over the IP solution with over 50 million users worldwide and a value exceeding 2,6 billion dollars as shown in news reports.

VIII. Conclusion

The main problem that we face today in the telecommunications society is that the services offered have become a basic necessity, almost like water because of the human want of communication. Therefore it becomes crucial to ensure a fair distribution of this necessity. Communicating with others at affordable prices is tantamount to the information society and it can only be achieved through competition between companies. There could of course be a monopoly in charge offering the services at cheap prices guaranteed by the State but this is a more anachronistic option. It is also not an alternative to have a concentrated market with a few powerful companies sharing profits.

The telecom markets in all of Europe are characterised by being at a first-stage of liberalisation where former monopolies upon becoming private enterprises have retained most of their market power.

Ideally, liberalisation will follow the following steps: privatisation; a significant increase in the number of players within mobile and internet segments; a partial entry into fixed telephony coupled with full competition on the other two markets and less regulation; and finally, total entry in fixed telephony in addition to mobile and Internet with companies holding individually less than 20% of the market.

Observation tells us that many European markets are at the first stage of liberalisation and therefore ex ante regulation and ex post control is necessary. In this sense, it could be wise to introduce a new European regulation to deal with price abuses under article 82, containing detailed guidelines and procedures narrowly defining what PP is to enable private companies to adapt their conducts to the prescribed rules and in accordance with the principles of legal certainty and legitimate expectations enshrined in European law.¹⁷⁰

¹⁷⁰ See C-107/97, at ¶ 66

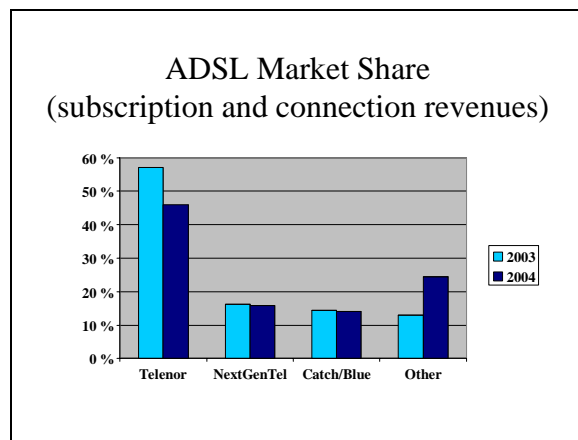
Alternatively, sector specific laws may either complement or even replace competition laws in the telecom sector when the latter cannot be applied adequately. This would require new transitory provisions that first, elucidate in a plain manner the tasks to be accomplished by competition authorities and NRAs in the handling of abusive behaviour complaints to avoid the multiplicity of administrative decisions, and second, solve which body of law should prevail in case of a conflict.

Laws also have to take good account of the realities they are regulating because theory does not exist in a vacuum and therefore the dynamics of the markets subject to regulations have to be examined continuously. Particularly, authorities have to realise that predatory pricing is rare in the context of Internet because competition is more spread in this area.

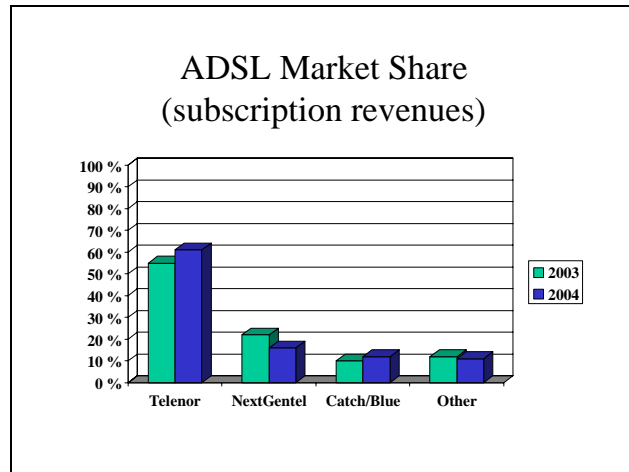
Legislators also have to consider that in many occasions the legal tests applied by investigators in cases of abuse of dominance are chosen arbitrarily. Practitioners complain that margin squeeze and predatory pricing give almost identical results in the telecom business, so how do we select?

A new EU regulation dealing with all these aspects could perhaps answer that question.

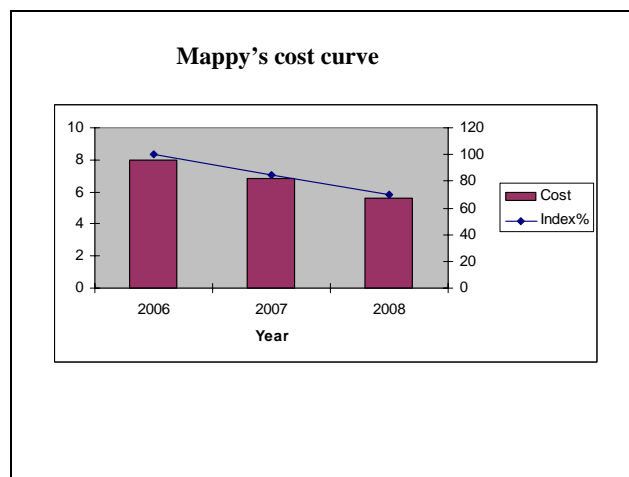
IX. Annexe



Slide 1



Slide 2



Slide 3

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