



## **THE ECONOMIC BASIS FOR POSSIBLE FINES AND DAMAGES UNDER ARTICLE 82**

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### **Introduction**

The Competition Act 1998 incorporates into UK law a prohibition of conduct amounting to the abuse of a dominant position (the Chapter II prohibition) in terms precisely equivalent to Article 82 of the EC Treaty. The Act enjoins the UK competition authorities to have regard to EC jurisprudence and policy statements in enforcing the UK prohibition. Moreover, since May 2004, the OFT has been empowered to enforce EC competition law in the UK as well as the national competition law. These developments have been widely welcomed and the resources available to the competition authorities have been significantly increased in anticipation of a more vigorous enforcement of the strengthened law.

Abusive conduct is unlawful *ab initio*, that is without a prior investigation and decision by the competition authorities. To be effective, firms need to know the types of business conduct that will be unlawful under this provision.

This article argues that application of a prohibition of conduct amounting to the abuse of a dominant position needs to be based on economic principles and an assessment of the effects of business conduct and practices (on the competitive process and on consumer welfare) not on the legal form or nature of the conduct or practice, and that the *per se* prohibition of particular types of conduct or practice will rarely be justified.

The position contrasts clearly with Article 81 and the Chapter 1 prohibition, where what behaviour is illegal is reasonably clear.

### **Dominance**

#### *Market definitions*

A recent paper suggests that it may not be necessary to consider whether firms potentially liable to allegations of abuse of a dominant position have large market shares in depth, since abuse could only be committed by a company with dominance and the question on which to concentrate is whether there has been an abuse.<sup>2</sup> However, this position is perhaps unlikely to be influential with the authorities, who need a practical means of sifting through potential complaints; the legislators were surely right in supposing that there is a need for some form of jurisdictional

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<sup>1</sup> Europe Economics ([www.europe-economics.com](http://www.europe-economics.com))

<sup>2</sup> Report by the EAGCP "An economic approach to Article 82" July 2005, Patrick Rey et.al.



threshold or test if the authorities' task is to be manageable, and, contrary to the authors, to reduce legal uncertainty. In considering abuse of dominance cases it is therefore natural to begin by assessing whether the companies concerned will be found to be in a dominant position.

However although a large market share may be a good indicator of dominance, applying that idea for the purposes of analysing a potential case of abuse of a dominant position is not altogether straightforward. In the context of mergers, thanks to the ideas introduced in the 1982 US Department of Justice merger guidelines and developed since, there is a good basis for understanding how to define relevant markets.<sup>3</sup> But this established approach is less use in considering whether the products or services supplied by an existing company represent a high share of a relevant market. Suppose a total monopoly in which prices are at the profit-maximising level. Unless one can calculate whether the possible monopolist's prices are above an efficient or competitive level the techniques relevant to assessing mergers are not much help.

An assessment whether prices are above competitive levels can be attempted if one takes a view on whether or not the company's profitability is above normal levels, or on whether its costs are higher than competitive levels; but strong assumptions are likely to be needed in pursuing either route. It will be difficult for the authorities to establish the correct answer to this question, and more difficult for a company to decide for itself.

The considerations are quite different if one is considering the use of this kind of analysis in *ex ante* regulation, such as applies to the utilities. Here it is reasonable for the regulator to make studies of the likely costs of an efficient operator, including the cost of capital, and to use these estimates to inform its decision as to the levels of prices that it is reasonable to allow the incumbent monopoly business to charge. But such studies take a long time and a great deal of information and analysis about which legitimate debate can take place; they could not realistically be a model for assessments by companies of whether or not their costs are likely to be found on investigation to be above efficient or competitive levels.

The variable, ordinary terminology of businessmen, or commentators, or compilers of statistical and market research studies, may give useful indications and form part of the totality of the evidence, without any particular element being relied upon in isolation. Nor should precedent from previous legal cases be relied on; in particular, it would be hazardous to rely on market definitions used in merger cases to decide what would be the relevant market for assessing whether an allegedly dominant firm in fact already has a large share of a relevant market. In the case of possible dominance, the key questions might be whether existing costs and profits are at an efficient level, whereas in a merger case the central question would be whether the merger would significantly reduce a competitive constraint. Such different analytical approaches may well lead to different results.

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<sup>3</sup> "SSNIP test", where SSNIP stands for "small but significant and non-transitory increase in price", and is also known as "hypothetical monopolist test", as the test seeks to identify the smallest market within which a hypothetical monopolist could profitably impose a small but significant non-transitory increase in price. Normally it is defined to be a price increase of 5 per cent for at least 12 months.



### *Freedom to act independently*

In *Hoffman la Roche* the Court of Justice defined dominance as follows:

“The dominant position referred to in Article [82] of the Treaty relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers”.<sup>4</sup>

This definition is frequently referred to. However, it is not of much practical help to a company wondering whether its market strength would amount to dominance. Taken literally, any firm can behave independently within the law and its particular contracts. The interesting question is the extent to which it could do so without losing profits. A monopolist pricing at the profit-maximising level might lose as much from a price increase, leading its customers to do without its monopoly supply, as a firm with competitors whose profit loss from a price increase would result from customers switching to other suppliers.<sup>5</sup>

So although of course the establishment of the relevant market, and the calculation of market shares, reinforced by some analysis of entry barriers and hence the ease of entry to the market and by assessments of efficiency, are tasks that have often been done in the course of competition investigations, there is nothing approaching a safe practical calculation or assessment that a company can make to decide what are the definitions of its relevant markets, or whether it is “dominant” under the law.

### **Abuse**

Many companies may nevertheless be prepared to accept that there is a risk that they *might* be found to be “dominant” in a competition investigation, and will want to understand what they are and are not allowed to do so as to avoid the risk of having to pay fines or becoming liable for damages. There are a number of business practices which might be abuses under Article 82 or Chapter II of the Competition Act. A few examples are given below to illustrate the main theme of this article.

#### *Predation*

The notion that pricing below cost could result in so diminishing the number of competitors and effectiveness of competition that a subsequent price increase beyond the competitive level will be possible has been much debated. A presumption has become accepted (since the judgement in AKZO) that pricing below “average variable cost” (the average of those costs that vary according to the amount of output produced and a proxy for the economist’s concept of marginal cost) will be predatory since there appears to be no rational reason why a business should deliberately

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<sup>4</sup> European Court of Justice, *Hoffman la Roche v European Commission*, C85/76, 13 February 1979.

<sup>5</sup> There are particular difficulties in determining whether there is collective dominance and whether the conduct of the collectively dominant firms amounts to an abuse, difficulties that are not addressed in this article



reduce its profits this way other than a desire to eliminate a competitor or prevent new entry.<sup>6</sup> This presumption is less useful than it might appear.

In the first place, the measurement of “average variable cost” will in almost all imaginable circumstances depend on the time scale over which costs are assumed to vary. The costs that are saved (or “avoided”) by a reduction in the level of output vary with the time over which the reduction takes place. For example: suppose a restaurant has bought enough fresh food for the expected number of meals to be served in an evening, and is paying its staff by the hour, the avoidable cost to the firm of not serving one more portion might be almost nothing. If it sells that portion at a very low price it may be receiving less than average variable cost of the ingredients, but it would not be wasting money nor would it be behaving in an anti-competitive manner. Or consider a cruise ship with costs sunk in commitment to a scheduled departure; the rational pricing policy of the owners will be to vary prices through time as the planned departure date approaches- perhaps low for early bookings, to get things going; then higher; then lower again as departure approaches if not all the seats have been sold. This is not anti-competitive price discrimination, but sensible behaviour designed to lead to an efficient outcome. The very low prices to airline “standby” passengers reflected the same basic economics: such variations in price through time do not mean that some are above and some below a properly conceived measure of average variable cost.

Both examples turn on what is the relevant timeframe. There is however no clear principle by which a company can know what timeframe would or should be used by a competition authority in reviewing average variable costs as part of an assessment of alleged predation.

There may be objective justifications for selling below cost, at least for a short time and in particular circumstances. Consider the firm that is short of orders, but wants to keep its workforce and other assets together in the hope or expectation of busier times ahead and so bids very low for a new contract. In assessing its avoidable costs account needs to be taken of not just the wages and materials used, which may not be exceeded by short-term revenues, but the chances of future profits. Again, measurement is highly problematic; so that reasonable people might take different views. Comparisons with “average variable costs” are certainly relevant but they are not a simple or straightforward basis on which firms can judge whether their behaviour is likely to be in breach of Article 82.

It is sometimes suggested that the question for consideration should be whether the strategy only makes sense as a plan to eliminate a competitor/competitors. But this would take us into an intents-based approach; an effects-based assessment should concentrate on whether the consumers are likely to be better off without the strategy in question, and not be concerned with what might be thought or said within a company about the prospects of competitors.<sup>7</sup>

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<sup>6</sup> European Court of Justice, Case 62/86, *AKZO Chemie v Commission*, 03 July 1991.

<sup>7</sup> Since the AKZO judgement predation can be established if price is above AVC but below ATC if there is evidence of intent to eliminate a competitor, in following this precedent one is inevitably taken back into the question of intent/motive.



The economics discussions of predation have also underlined that this strategy is not credible unless the alleged predator can see the prospects of recoupment of losses incurred. This will be very difficult to establish; at least, without reliance on a great deal of speculation.

For all these reasons, the question whether a company is pricing above average variable costs may often be a useful starting point for analysis, but it is not in itself an operational economic principle that can be used by firms to decide whether or not they are likely to be found guilty of an offence under Article 82, nor should it be used as such.

When turning from predation to other possible alleged abuses of Article 82 the position becomes even more uncertain.

### *Margin squeeze and rebates*

Consider exclusionary behaviour through margin (or price) squeezes or loyalty rebates. Both of these practices are considered to be potential abuses of a dominant position and even candidates for a *per se* prohibition.

Let us first consider these ideas in relation to a dominant company with an interest in a downstream market – for example, a patented pharmaceutical manufacturer interested in the distribution of its medicines. It might not be willing to allow independent distributors to have supplies of the medicine on terms that make it possible for them to compete with its own activities in the downstream market. Excluded wholesalers might complain, and perhaps after investigation the authorities might decide that competition would be enhanced and consumer welfare improved if the company were obliged to change its policies, and allow a competitive market in delivery services to develop. If such a case were investigated under Article 82, the manufacturer could be found to have committed an offence, and be liable to be fined and/or sued for damages. However, it is still doubtful whether fines or liability to damages should apply, because the rival stories would both have been reasonable. The standard of proof appropriate for a punishment is different from the assessment whether on the balance of arguments one set of arrangements or the other was likely to be the more beneficial for consumers.

Or imagine slightly different facts from those in the recent *Genzyme* case<sup>8</sup>, namely that the patent-holders want to ensure that the wholesalers that handle their products keep reliable records and are able to track any particular batch or individual package (this is now quite feasible). Suppose they decide that the only safe way of ensuring this is to distribute the medicines to pharmacists and hospitals themselves. This they might argue would improve the safety of the medicines and hence the general reputation and profitability of the patent-holders. Carrying out the distribution function itself could only add to the manufacturers' profits if self-distribution is less costly than distribution through independent wholesalers (since otherwise it would not reduce the overall cost of getting the products to market). In these circumstances it would be a mistake for competition law to require the continuation of the less reliable and more costly arrangements.

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<sup>8</sup> Competition Appeal Tribunal, Case 1015/1/1/03, *Genzyme Limited v Office of Fair Trading*.



What of loyalty rebates? One can easily see that a dominant firm might try to consolidate its position by making it expensive for its customers to experiment with alternatives; and that rebates having this effect could reduce the strength of competition. Such rebates would increase the (marketing) costs of competitors. But on the other hand, any strong presumption against such rebates or equivalent practices would not be justifiable. It is a characteristic of successful businesses to have good relationships with customers; and indeed a continuing commercial relationship brings many efficiencies. So it is entirely to be expected that an efficient firm will reward its loyal customers in various ways – from the restaurant reserving a favourite table for its regular customers, to the entertainments provided by some firms to their clients and distributors, to the particular priority given to a last-minute order, and so on. To include a price rebate as part of this cannot be inherently anti-competitive.

It is clear that loyalty rebates, or equivalent ways of rewarding and encouraging continuing commercial relationships, are desirable (certainly should not be discouraged) up to a point; but that beyond that point they may be a vehicle for an abuse. This implies that they are a proper subject for investigation by the competition authorities, but not necessarily a proper subject for penalization *ex post*.

#### *Price discrimination*

Let us now consider a perhaps even more important type of business practice that has been held to be potentially abusive when engaged in by a dominant firm, and this is the practice of price discrimination, defined as charging different customers different prices for the same product or service or more generally “applying dissimilar conditions to equivalent transactions with other trading parties thereby placing them at a competitive disadvantage”. Ought it to be an offense to charge what the market will bear, rather than to charge all customers the same (after allowing for differences in their transport and other such costs)?

There are some circumstances in which price discrimination should be prevented. Textbooks point out that a monopolist can maximise its returns by discrimination all the way up the demand curve; charging each customer the most they are willing to pay; and that this is not possible in a competitive context. It might be thought that uncontroversial examples of contexts in which discrimination should be prohibited would be the formerly nationalized industries, perhaps still operating with exclusive licences. Their monopolies were derived from the government, representing taxpayers, and the sense that discrimination is unfair seems particularly strong in these circumstances. It is thus not surprising if utility regulators give more weight to distribution/fairness questions than do competition authorities in general.

Where price discrimination by a dominant firm has the effect of preventing competition, or the emergence of competition, it may be considered an abuse, even if the discrimination falls short of predatory pricing. It will often take the form of selective price cuts, discounts or rebates targeted on the customers of the putative competitor.

However, a fuller analysis can easily point in the opposite direction. First, price discrimination is likely to be efficient wherever there are significant sunk costs. This is a widespread situation in the utility and transport industries. In the railways, for example; charges for the use of particular



lines of track that would otherwise be unused ought not to be such as to prevent the track being used provided that the incremental costs of use are recovered.

The principles of Ramsey pricing derive from the rules that would make taxation distort the economy as little as possible; but they apply to the recovery of overheads from a range of customers as much as to taxation. Charging what the market will bear is the efficient way of doing this.

Second, in an oligopolistic market, it is highly likely that any price competition will take the form of selective price reductions, special discounts and deals which rival firms will find it more difficult to detect and quickly to match. Oligopolists are likely to be dominant, whether individually or collectively, and the effect of prohibiting discrimination could be to prevent any price competition.

There has been a long-running argument over the issue of discriminatory conduct in the context of the parallel trade within the EU of patented pharmaceuticals. The EC has supported the rights of arbitrageurs to buy patented pharmaceuticals in any part of the EU and re-export them to other countries in which the patent-holder is charging a higher price, seeing this as part of creating a single European market. The pharmaceutical industry has sought to prevent such arbitrage as it reduces the profits that can be made whilst the products are in patent, and reduces the access of patients in low income countries to patented medicines.

One of the current debates around Article 82 concerns this issue. A Greek wholesaler has instituted proceedings against GlaxoSmithKline (GSK) for refusing supplies, which GSK thought were destined for re-export.<sup>9</sup> This case has particular resonance since it follows the failure of the Commission to prevent another pharmaceutical company, Bayer, from limiting supplies to its distributors under Article 81 (the Commission thought there was an agreement between Bayer and its distributors but the distributors never agreed: the policy was imposed unilaterally and so it seems that if it is against the competition law it is against Article 82). The Advocate General's opinion concludes in effect that GSK is entitled to charge discriminatory prices.<sup>10</sup> Unfortunately perhaps, the ECJ decided that it did not need to address the issue since the Greek competition authority was not qualified to refer such questions.

These examples demonstrate that even such an apparently straightforward principle as that a dominant firm should not be permitted to practice price discrimination is not applicable without important exceptions. It may be desirable to prevent this sort of pricing, or it may be highly desirable not to do so. It depends on how one analyses the facts of the case in question.

### *Excessive pricing*

The same is true of another major potential type of abuse of a dominant position, through overcharging, or exploitative (as opposed to exclusionary) abuse. The notion that a competition authority can decide whether prices charged are excessive, unless (as in *Napp*<sup>11</sup>) this is in the

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<sup>9</sup> European Court of Justice, Case C53/03, *SYFAIT v GlaxoSmithKline*.

<sup>10</sup> European Court of Justice, Advocate General's opinion in Case C53/03, *SYFAIT v GlaxoSmithKline*, 28 October 2004.

<sup>11</sup> Competition Appeal Tribunal, Case 1001/1/1/01, *Napp Pharmaceutical Holdings Limited and Subsidiaries v Director General of Fair Trading*.



context of having found an exclusionary abuse that enables the high prices to be sustained, is highly problematic. There is room for reasonable debate about the rate of return appropriate to different companies in different sectors and in different market conditions. There is equal room for debate about all aspects of the measurement of efficiency, including how to decide whether the rates of pay, and manning levels, are “competitive”, or a bit high, or outrageous. If the competition authority determines that a price is “excessive” and an abuse of a dominant position, it will then find itself in the uncomfortable position of having to decide what would be an acceptable price and presumably to regulate the firm’s prices thereafter. Economists know how to go about addressing these and all the other issues that one needs to address in reaching an informed and reasonably robust view on what price might be regarded as competitive in particular circumstances. But the guidelines that might sensibly be followed in such matters by those analyzing a particular case cannot easily be translated into operational general rules or even principles that any firm can be expected to understand and reliably apply to its own policies and charges, in order to decide whether or not it might be guilty of an offence under Article 82 or the Competition Act. And quite aside from the practicalities, there is the fundamental question whether it is wise policy to limit the profits of the dominant firm by an enforced price reduction and thereby reduce the incentives for potential competitors to enter the market.

### **Fines and damages**

The law requires that before fines or damages are applied, there must have been negligence or intent to break the law. The points argued above all point in the direction of not levying fines for infringements of Article 82 or Chapter II of the Competition Act in circumstances in which the firm concerned would have been in reasonable doubt about whether or not its conduct was an infringement of the law. If such fines are imposed, the rational response of firms will be to refrain from practices that might make them liable. This would in some circumstances reduce rather than improve the competitive process and hence general economic wellbeing.

Imagine the play-safe advice a law firm or consultancy might be obliged to render; and the negative effects this would have within companies considering more or less ambitious and aggressive business plans. To caricature a little to underline the point the advice might be:

“Do not over-charge; do not under-charge; make sure all customers are treated the same; make sure that any internal aggressive thoughts towards out-doing particular competitors are not recorded in emails or minutes<sup>12</sup> ; do not spend too much time promoting the unique advantages of some company asset lest competitors demand access to it and we have to grant it at cost. Do not spend too much marketing effort to promote the idea that our products have unique selling points lest this leads to a finding that we are dominant in a relevant market” and so on.

None of this means that the abuse of a dominant position prohibition should not be applied, but it does mean that unless there are circumstances in which the potential abuse is quite clear, to the point that it warrants a *per se* prohibition, the application should be prospective and not retrospective, meaning that the firm concerned should be prevented from continuing with the

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<sup>12</sup> Such advice is already appearing in law firm circulars to clients



practice in question, but not punished for having employed it in the past, before it had been clearly condemned. For example, if a loyalty rebate scheme is found to be an abuse, there should not be a fine but merely a requirement on the firm to abandon or modify the scheme to remove its anti-competitive features and not resurrect it. Fines would then be levied for infringements of clear and specific requirements, akin to the *ex ante* restraints imposed by the sector regulators.

Where damages are to be assessed, this too will be much safer in the circumstances in which a clear breach of a specific *ex ante* requirement has been established. One could add that the assessment of damages in the case of exclusionary abuses will always be much more difficult than in collusion cases. How could a court assess the damage suffered by a putative competitor kept out of the market by skillful pricing policies of a dominant incumbent? But the fundamental argument is the same as with regard to fines: unless and until definitions of abuse of a dominant position have been as clearly articulated and justified as the prohibitions on collusion and the like under Chapter 1, it would be unfair and inefficient for firms found to have acted unlawfully after a long and complex rule of reason investigation in which many contentious matters of judgement will arise to be punished for having done so in the past. The appropriate action by the authorities will be to bring the practice found to be an abuse to an end, not to levy a fine.

## Conclusion

The problem discussed in this article arises because economic analysis shows that while there are indeed possibilities of abuse of a dominant position, it is difficult to identify or define them without specifying and interpreting the facts of a particular situation; a “rule of reason” analysis is required.<sup>13</sup> This means that there are many practices on which clear general rules are unlikely to be achievable. It follows that the companies concerned have little chance of knowing with any certainty what behaviour would constitute an offence, or what the findings of an investigation would be. The generality of firms will have little chance of adjusting their behaviour to comply with the law in an efficient manner.

There may be some room for debate about the likely role of intent in the application of Article 82, although it (or negligence) is required before fines or damages are applied. The weight of opinion seems to be that the tests should be objective. If however (as the early AKZO case and some others imply) judgements do turn on interpretations of intent, then the basis for the law ceases to be the economic consequences of actions. This would raise a fundamental problem: there is no definitive answer to the question how one should distinguish for the purposes of competition law between vigorous competitive behaviour (or competition on the merits) and anti-competitive behaviour (or conduct that distorts and harms competition).<sup>14</sup> There is for example no way of knowing whether a business plan to take customers from competitors to such an extent that the competitors would exit from the market is pro- or anti-competitive.

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<sup>13</sup> Vickers, John (2004) “Abuse of market power”, *The Economic Journal*, 115 (June): F244-F261.

<sup>14</sup> John Vickers, Abuse of market power, speech to the 31st conference of the European Association for Research in Industrial Economics, Berlin 3 September 2004. “...the fundamental issue, which recurs in various guises and phrases, is the same in Europe, the US and elsewhere – how to distinguish between (unlawful) exclusionary or competition-distorting behaviour and (lawful) “competition on the merits” by firms with market power? The answer is less than clear...”



The focus should therefore be on the effects rather than on the intentions of the parties concerned.

If substantial fines and damages are a possibility in circumstances that cannot be sufficiently analysed and specified for firms to be confident how the authorities would conclude, the rational economic response will be to compete less aggressively; and that would not be a desirable outcome.

Breaches of the prohibition carry the risk of large financial penalties (fines) and can give rise to private actions for damages. However, the economic basis for the definition and assessment of abusive conduct by a dominant firm depends on facts particular to each situation and on their interpretation. This puts firms anxious to avoid behaviour contrary to the law in an extremely difficult position. The suggestion in this article is that the authorities, where an infringement is established, should generally limit themselves to remedial action that would effectively deal with abuse and prevent its recurrence and not consider the imposition of fines. It is not only unfair to impose fines in circumstances in which those concerned have no reasonable way of knowing what is and what is not an offence, it can lead to inefficient outcomes in the economy more generally, for example, if the threat of a fine discourages a firm from engaging in competitive and efficiency-enhancing activity which it fears might be regarded as an abuse. It also follows from the position taken in this article that there should be a strictly limited right of third parties to sue for damages.

This is not a facile call for “greater clarity” from the authorities. Where the facts vary and the analytical techniques are open to debate, the implication is rather that policy towards fines and damages on the one hand and the use of *ex ante* regulations and undertakings on the other hand should take full account of these inescapable uncertainties. This suggests that in general the authorities ought not levy fines or impose damages but concentrate on identifying where *ex ante* prohibitions (meaning remedies such as cease and desist orders or undertakings, directions/orders to change loyalty rebate schemes, and tie-in clauses) are needed, and on defining efficient interventions. Fines or damages for breach of such orders/undertakings would then be appropriate.