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Abuse of Dominance: Recent Developments in Competition Policy in the EU[♣]

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Recent years have seen important developments in competition policy in both the UK and EU. This paper focuses on developments in the area of market dominance under Article 82 in the EU. After a preliminary discussion of policy, the paper highlights two important cases (*Coca Cola* and *Microsoft*, both decisions in 2004). The paper also reviews recent proposals for reform of policy in this area and argues that there are significant weaknesses in current proposals for reform. The paper concludes with a summary of developments. **JEL codes: L12, L41.**

1. Introduction

Recent years have seen important changes in competition policy in both the UK and EU. In the UK, significant developments have occurred, first, in the 1998 Competition Act and also in the 2002 Enterprise Act. These developments have led to a radical change in UK policy aimed at bringing it more into line with EU policy in the areas of market dominance and agreements between firms although less so in merger policy. In the EU, while the basic articles of the EC Treaty remain in place, EC policy has been developed as a result of the 'Modernization Regulation' which came into force in May 2004. Also, in the case of the abuse of market dominance (the focus of this paper) a review of policy is currently underway which may lead to substantial changes in the way policy on market dominance will operate in the future. This and current developments in the policy on the abuse of dominance are the main topics of this paper.

In what follows, I describe current policy on dominant firms at EU level in section 2 and briefly discuss the new Modernization Regulation. This is followed in section 3 by a consideration of two important recent cases. Section 4 outlines the proposals for reform currently under review by the European Commission and identifies some

important problems with these proposals. Finally, section 5 provides a summary and conclusions.

2. EU Policy on Dominant Firms

Current policy on dominant firms in the EU is based on Article 82 of the EC Treaty. Under this Article:

Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it .. [is] .. prohibited as incompatible with the common market in so far as it may affect trade between Member States (EC Treaty, Article 82).

The article also lays down several examples of what may be seen to be an abuse of a dominant position although these examples are not exhaustive and are not discussed further here.

Under the policy, the European Commission (DGIV) and, more recently, national competition authorities (NCAs), are required to keep markets under review, and, if necessary, to undertake investigations of possible abuses of a dominant position. In doing this the Commission and the NCAs are required to define both the market in which the abuse is said to have taken place and consider whether a dominant firm is involved. The Commission has developed procedures over time to deal with these issues which have been supported by the decisions of the European courts. In the case where evidence of an abuse has been found, the Commission can prohibit behaviour leading to the abuse and fine the firms involved. Firms have the option of appealing the Commission's decision to the European courts both on the decision itself and on the level of the fine.

In determining possible abuse of a dominant position, the Commission must both define the relevant market and establish that a dominant position exists. In the case of market definition, it uses the well-known SSNIP test which is used widely in other jurisdictions including the US. Although this is widely known it can be considered briefly here. Under the test, a single firm (or group of firms) is considered and the question is asked: is it possible for these firms profitably to make a Small but Significant Non-transitory Increase in Price (usually taken to be 5-10 per cent)? If the answer is 'no', either because consumers can switch to other products or obtain supplies from other geographic areas, the market is not defined widely enough and other products are added. The same test is applied and when, at some point, the answer turns out to be 'yes' the market is defined.

This approach has intuitive appeal but, as is well known (see, for example, Geroski and Griffith, 2004), there are several problems with it. In particular, the test is 'hypothetical' in that there may be no direct evidence of the likely effect of a small but significant non-transitory increase in price. Hence, it is a matter of judgement as to the effect of such a rise in price. In addition, the test assumes that the firm or firms concerned are able to raise price profitably above the competitive level. In practice, in Article 82 cases, prices in the market may be well above the competitive level and this further complicates the test.[1] Experience, however, has shown that the procedure often provides a satisfactory outcome in defining markets and is widely used in EU cases, as elsewhere.

The second issue of importance is the definition of a dominant position. In this case, the Commission takes the view that a

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[1] The failure to take this into account is known as the 'cellophane fallacy' following an important US case: see *United States v. EI du Pont de Nemour and Co*, 1956.

dominant position will exist if a firm has a 50 per cent market share or more although dominance may also be found if a firm has a market share between 40 and 50 per cent and, in some cases, even below 40 per cent (European Commission, 2005, p. 11). The Commission also considers other factors in determining dominance including the size and number of competitors, the existence of barriers to entry and off-setting buyer power. However, dominance itself is not seen as evidence of an abuse of a dominant position so establishing that dominance exists is only a preliminary part of an investigation.

Several changes in EU policy have been introduced more recently under the 'Modernization Regulation' which came into operation in 2004.[2] First, jurisdiction in Article 82 cases, has been extended, as noted above, to NCAs in addition to the Commission. This means that NCAs will generally deal with cases that predominantly occur within their Member State while the Commission maintains control of cases with a 'Community-wide' dimension. This change is likely to lead to more efficiency in the operation of policy. Second, new powers have been given to the Commission, and the NCAs, to accept commitments *in lieu* of a formal decision in Article 82 cases. The aim of this change is to speed up investigations, and to reduce their costs, also providing an opportunity for firms to avoid the possibility of a fine. Given that a fine can be up to 10 per cent of the world-wide turnover of a firm in a particular year, there is a strong incentive for firms to favour this route and an example of this is considered below.

3. Two Recent Cases

In this section, I briefly consider two recent cases examined by the European Commission under Article 82. I focus on two recent high profile cases: *Microsoft* (2004) and *Coca Cola* (2004).

Microsoft (2004)

In this case, Microsoft (the leading US software company) was found to be a dominant supplier in the PC operating system market in the EU, and was alleged to have abused its dominant position in two areas: first, in the work group server operating system market by not letting its rivals have full inter-operability information with Windows and, second, in bundling its Windows Media Player free with Windows. In the first, its policy prevented rival work group server operating system suppliers from competing on equal terms with it and, similarly, in the second, created a bias in favour of Microsoft's own media software. The Commission found both of these practices to be an abuse of its dominant position. As a result it ordered Microsoft to make full inter-operability information available to competing suppliers in the work group server market within 120 days, and to make copies of Windows available without (as well as with) its Windows Media Player within 90 days.[3] In addition, given the significance of the case, it imposed a fine of 497.2 million euros on Microsoft (1.6 per cent of its annual world-wide turnover at the time).

The major point of interest in this case has been the compliance (or lack of

[2] Council Regulation (EC) No. 1/2003 on the implementation of the rules laid down in Articles 81 and 82 of the Treaty, OJ LI 4, January 2003.

[3] With hindsight this seems an empty gesture in that customers faced with a Windows package with or without Windows Media Player would seem more likely to choose the one with the player.

compliance) of Microsoft in relation to work group server inter-operability. While Microsoft has made available some information on inter-operability with the Windows system this has been judged to be insufficient by the Commission. As a result there is currently a stand-off between the Commission and Microsoft. At time of writing, it is not clear if and when Microsoft will be judged to have complied and whether it will in the long run remains to be seen.[4]

Coca Cola (2004)

In this case the Coca Cola Company was found to have been involved in a number of practices which restricted competition in the market for carbonated soft drinks. Amongst other things, it was alleged that it restricted competition in retail outlets by providing free chiller cabinets to outlets on condition that they only be used to stock its products. In addition, in some cases, it imposed exclusive purchasing conditions on outlets which required outlets not to stock products of rival manufacturers and, again in some cases, to take the full range of products it supplied.

In this case, the Commission found that Coca Cola was a dominant supplier in a number of EU markets and that its practices restricted competition. However, it decided to accept legally binding commitments from Coca Cola under the new Modernization Regulation in place of a formal decision. These commitments were:

1. To allow retailers to stock other soft drinks in its chiller cabinets to at least 20 per cent of their capacity, if no other cabinets were available in an outlet.
2. Not to impose exclusive purchasing requirements on its customers.
3. Not to offer rebates to customers purely for the purchase of the same amount or more of its products, and
4. Not to use tie-ins to link other products to the main products that it supplies.

These commitments are legally binding for a period of five years.

The interest in this case is in the use of commitments in place of a formal decision in a dominant firm case. Coca Cola, with the prospect of an adverse decision, and possibly a very high fine, took the view that it would be better to offer commitments to bring the investigation to an end. The case illustrates the point that commitments can be an effective way of producing market change, and it seems likely that they will be used more widely in future years.

4. New Developments

Most recently, the European Commission has initiated a review of policy in the dominant firm area with the publication of a Discussion Paper (European Commission, 2005) in December 2005. This section discusses the main suggestions in this paper and the problems that appear to arise.

In the paper, the Commission essentially considers two areas of reform: the introduction of an 'as-efficient competitor test' and the use of an efficiency defence in Article 82 cases. Taking the as-efficient competitor test first, the Commission argues that behaviour by a dominant firm which would not harm in a significant way an as-efficient competitor as the dominant firm (and hence the dominant firm itself) should *not* be seen as an abuse of a dominant position ('safe harbour'). On the other hand, if such behaviour would significantly affect an as-efficient competitor there would be evidence of 'capability' of an abuse and the case would

[4] Microsoft is currently being fined three million euros a day for non-compliance but this has not apparently forced it to comply with the Commission's conditions.

be looked at further (European Commission, 2005, pp. 20-1). The advantage of this approach is that it would protect equally efficient firms from anti-competitive behaviour by a dominant firm but not protect less efficient firms who raise the overall costs of production of a good.

While this test seems intuitively appealing it has important weaknesses. First, at a practical level, problems arise in measuring costs such as allocating common costs between activities for multi-product firms and in the treatment of fixed costs (see European Commission, 2005, p. 20; Clarke, 2006, p. 44). These problems make it difficult to determine the basis on which an as-efficient competitor test can be applied. Added to this, it may be difficult to obtain reliable evidence from the dominant firm itself on the true level of its costs. These issues can be considered more widely but clearly give rise to important practical problems in the application of the test.

More importantly, however, problems arise at a theoretical level. While it seems reasonable not to protect less efficient firms in a competitive market, it is well known that this need not apply if markets are less than perfectly competitive (Vickers, 2005, p. F256). At the margin, a firm which is *just* less efficient than a dominant firm will raise the total cost of production (slightly) but at the same time will tend to reduce market prices. Hence, a trade-off will exist and it is likely that some level of inefficiency will increase economic welfare despite the inefficiency effect. This is more so if more emphasis is given to the effect on consumer welfare (which it often is in this context) because more competition directly reduces prices and makes consumers better off. Hence, allowing dominant firms to adopt policies that weaken or eliminate less efficient firms is not likely to be desirable in many cases.

It can be shown using conventional economic models that this policy would give rise to welfare losses. In the Cournot model, for example, elimination of a less efficient competitor will typically raise price (although not by much if a very inefficient, and hence small, firm is eliminated) while economic welfare will increase only if a very inefficient firm leaves the market (Lahiri and Ono, 1988). Hence, on a welfare standard, elimination of a less inefficient firm will tend to reduce economic welfare except where very inefficient firms are involved. In the Bertrand case (with production differentiation) the policy can lead to an increase in price and a reduction in welfare if two firms are involved,[5] although, more generally, removal of a very inefficient firm may increase economic welfare as before.

These arguments are strengthened, as recognised in the Discussion Paper, if firms are not as efficient as a dominant firm but may become so later: for example, because of learning effects or first-mover advantages initially enjoyed by dominant firms. These arguments suggest that the application of the as-inefficient competitor test as presently conceived could damage both consumer and economic welfare.

The Commission has also proposed the introduction of an efficiency defence in Article 82 cases, which can be dealt with more briefly. In this case, it proposes four conditions under which an efficiency defence could be used:

1. That efficiencies are realised or likely to be realised as a result of the conduct concerned.
2. That this conduct concerned is indispensable to realise these efficiencies.
3. That the efficiencies benefit consumers, and

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[5] This result follows from a model developed in a different context by Clarke and Collie (2003).

4. That competition in respect of a substantial part of the products concerned is not eliminated (European Commission, 2005, p. 26).

The first condition is to be interpreted widely to include conduct which contributes to the improvement of production or distribution, or the promotion of technical or economic progress, and to include, for example, producing better quality products as well as making cost savings. The second requires conduct to be indispensable to obtain these benefits. The third emphasises the point noted above that it is often necessary to show that there are real benefits to consumers in EU competition cases while the fourth makes the point that for very dominant firms (the Discussion Paper suggests a market share above 75 per cent, where competition in the rest of the market is weak and there are substantial barriers to entry) it would not be appropriate to accept an efficiency defence. This is because the basic principle underlying the policy that restriction of competition should be avoided over-rides other considerations in such cases.

The changes in relation to efficiencies have the merit that they bring policy under Article 82 more closely into line with other areas of competition policy in that they offer the possibility that a firm can claim efficiencies (and other benefits) from their behaviour as part of their defence. Given that it is still unlikely that serious abuses could be justified by an efficiency defence, especially where a dominant firm has a very high market share, it seems likely that this change will not have a major effect on the operation of policy if adopted.

5. Summary and Conclusions

This paper has considered developments of EU policy on the abuse of a dominant position. Whilst, on one level, developments have been relatively modest in recent years, below the surface considerable change has been taking place. This has been linked to the Modernization Regulation introduced in May 2004 and, in particular, to the introduction of commitments in addition to formal decisions in Article 82 cases. This has been seen, in particular, in *Coca Cola* (2004) where commitments have been accepted by the Commission *in lieu* of a final decision. More recently, the Commission has undertaken a review of EU policy under Article 82 and suggested possible proposals for reform. While its proposals for the introduction of an efficiency defence in Article 82 cases seem reasonable, it is less clear that the proposal to use an as-efficient competitor test can be defended. The argument presented suggests that policy should place more emphasis on the protection of competition, rather than protection of as-efficient competitors. Whether and in what form policy change will take place, however, remains to be seen.

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♣ *The views expressed here are personal to the authors and do not necessarily reflect those of the other staff, faculty or students of this or any other institution.*

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Book Review:

Greg Hill. (2006) Rousseau's Theory of Human Association: Transparent and Opaque Communities. Published by Palgrave Macmillan. New York. PP 216. ISBN 1-40397-259-1.

Hill's primary achievement is to expose an underlying and hitherto under-theorised dimension of political philosophy – that of the various degrees of transparency in human relations, and how this pertains to the possibilities for political community. His case is interesting and credible, with contemporary relevance. As political philosophy this is excellent: within this framework, Rousseau is given comparative treatment with Thomas Hobbes and Adam Smith, before turning to a set of contemporary normative political philosophers – David Gauthier, Bruce Ackerman, and that perennial figure in the discipline, John Rawls. The Rousseau-Foucault tension, however, is paid lip service to without being developed: a chapter here would have been interesting. Still, this monograph should be read by political philosophers of all persuasions.

The secondary achievement of the book is to demonstrate the wider utility of game theoretical approaches in political philosophy. This is an opportunity for those already utilising this approach (in regard to Hobbes and Rawls commonly) to broaden their curriculum somewhat. As game theory, this is good: Hill demonstrates firm control of games, keeps his models simple, and they are important to the scheme of transparency/opacity he is developing here. Hill clearly contributes to the view that game theoretical models can help cut to the core of otherwise complex and perhaps esoteric philosophical works and problems.

As to the contemporary relevance, Hill's conclusions can be read as radically egalitarian. In Britain, inequality of wealth is an issue off the political agenda. New Labour has spent its time in office, not unreasonably, pursuing the Rawlsian objective of making the worse-off better-off in absolute terms, while publicly and explicitly ignoring the growing inequalities of wealth. However, Hill provides philosophical ammunition for what many already feel is a historical mistake – if more egalitarian societies have greater levels of political community (therefore a healthier society overall), then the increasing inequalities in Britain over the last 30 years are damaging the society, making social problems worse (and making collective actions to solve them harder), and contributing to a failure in provision of basic public goods (such as trust perhaps). Current Conservative Party claims regarding a 'broken society' are clearly not without credibility in the electorate as a whole. However, a party historically and ideologically rejecting egalitarianism is, in this analysis, unlikely to able to provide solutions.

A sceptical front must be maintained on the claim that the forces of globalisation are exacerbating such problems. The author's

use of inverted commas around the concept globalisation suggests awareness of issues which are not addressed. Indeed, most of the empirical, comparative literature which does address globalisation suggests that the 'race to the bottom' is about as empirically grounded as the 'tragedy of the commons'! Of course, the narrative of globalisation has certainly been important in driving policy changes towards an in-egalitarian state, not least in Britain. It may well take a global capitalist crisis reminiscent of how previous eras of *laissez-faire* came to an end for people to be less hypnotised by the 'opportunities of globalisation', and more willing to embrace a radical, egalitarian-distributive state that, following Hill, might minimise the problems of social breakdown and violence, as well as those of inter-generational unemployment and welfare dependency. Hill is right to also address such critiques of the welfare state, as in its current form it appears to contribute to these problems *without* redressing social inequality.

Hill's findings are not a set of abstract claims, then, but important ones with contemporary relevance, placing him in the heartland of contemporary normative political philosophy. It is perhaps a little weighty for undergraduates or for courses on social policy, but while my reading may be biased or selective, this work definitely has applications across a range of contemporary social problems. Nonetheless, this is an enjoyable read, a good piece of work, and I would definitely recommend this to those interested in political thought, political philosophy, and game theory – and heavily recommend it to those teaching any of these three subject areas.

Michael Keating

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