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Predatory Pricing – Analysis of CFI Judgment in *France Telecom*.

Introduction.
On 30th January, the European Court of First Instance rejected an appeal by *France Telecom* against a Commission finding that its *Wanadoo* subsidiary had abused a dominant position in the French market for residential high speed internet access by engaging in predatory pricing. The judgment raises a number of interesting issues. In particular, the Court held that a dominant firm may not match a competitor's prices, if such prices would cause it to sell below cost.

Background.
In July 1999 the EU Commission began an investigation into local loop unbundling. During the course of this investigation it also reviewed *Wanadoo's* prices for its high speed internet (ADSL) services for residential customers. On 16th July 2003 the Commission took a decision in which it found that *Wanadoo* had abused a dominant position by charging predatory prices for its ADSL services to residential customers.

The Commission found that in the period from March to August 2001, the prices charged did not cover *Wanadoo's* variable costs. The Commission also found that between August 2001 and October 2002 *Wanadoo's* prices for ADSL services were less than the total cost of providing such services and that this pricing strategy was part of a plan to pre-empt the market for high-speed internet services.[1]

Grounds of Appeal.
France Telecom appealed the Commission decision on a number of grounds. The main economic arguments raised in the appeal were that the Commission:

1. Had defined the market incorrectly.
2. Was incorrect in finding *Wanadoo* dominant.
3. Applied the wrong cost recovery test.
4. Made gross errors in its cost calculations.

[1] The Commission cited various internal company documents as evidence of predatory intent.

5. Denied *Wanadoo* the right to align its prices with those of its competitors.
6. Erred in finding that there had been a plan to engage in predatory pricing.
7. Erred in maintaining that proof of recoupment was not necessary to establish predatory behaviour.

Some of these points are now considered.[2]

Market Definition.

Wanadoo argued that the Commission was wrong in finding that the market for high speed internet access was separate to the market for low speed internet access. This argument was rejected by the Court.

The Court considered a range of evidence including the SSNIP test. It quoted from the Commission's Notice on Market Definition regarding the application of the SSNIP test that "[t]he question to be answered is whether the parties' customers would switch to readily available substitutes … in response to a hypothetical small (in the range 5 % to 10 %) but permanent relative price increase in the products and areas being considered".[3] The Court then went on to note that a survey of customers found that 80% of customers would not switch from high speed access in the event of a price increase of 5-10%. It then concluded that "this high percentage of subscribers who would not abandon high-speed access in response to a price increase of 5% to 10% provides a strong indication of the absence of demand-side substitution."[4]

In applying the SSNIP test to define the relevant market, the issue is whether enough customers would switch in response to a modest price increase to make such a price increase unprofitable. A price increase means higher profits per item sold but will also lead to a decline in the quantity sold. It is relatively easy to calculate the volume of sales that can be lost in response to a price increase such that profits are left unchanged. This is known as the "critical loss" and the following table shows the value of the critical loss for various levels of price-cost margin.

Critical Loss Values

% Price-Cost Margin	% Price Increase	
	5	10
50	9.1	16.7
45	10.0	18.2
40	11.1	20.0
35	12.5	22.2
30	14.3	25.0
25	16.7	28.6
20	20.0	33.3
15	25.0	40.0
10	33.3	50.0

Take the case where before the price increase the price-cost margin is 35%. In the case of a 5% price increase, the critical loss is 12.5%, i.e. sales would have to decline by more than 12.5% for the price increase to be unprofitable.

The survey data cited by the Court indicated that 80% of customers would not switch in the case of a 5-10% price increase. The fact that 20% would switch may be sufficient to make the price increase unprofitable. In the case of a 5% price increase this would be true if the price-cost margin before the price rise was greater than 20%. It would take a price cost margin of more than 40% to make a 10% price rise unprofitable.

[2] *France Telecom* also raised a number of legal procedural grounds for appeal, which are not addressed in this article. The question of the cost recovery test and cost calculations are also not addressed here.

[3] At para 87.

[4] At para 90.

Such price-cost margins are not necessarily unusual.[5]

The difficulty with the Court's reasoning is that it appears to imply a view that a large proportion of customers would have to switch in order to establish that there are products that are sufficiently close substitutes as to be considered part of the relevant market. As the table shows, this is only true where the price cost margin is relatively low. In other words the fact that a large proportion of customers might not switch in response to a price increase, of itself, does not establish a lack of demand side substitution. Considering the proportion of customers who would or would not switch in isolation is not enough; such figures need to be viewed against the critical loss yardstick.

Market Shares and Dominance.

The appellant also argued that evidence on market shares alone were insufficient to establish dominance in what was an emerging market for a new product. The Court again rejected this argument citing precedent that high market shares were, in themselves, evidence of dominance.[6]

The Court noted that *Wanadoo's* share of the market reached 50% on 31 March 2001, increased to 72% on 31 March 2002, and remained at that level until August 2002.[7] According to the parties' replies to the questions put by the Court that share subsequently dropped to 63.6% in October 2002 according to *Wanadoo* and to a figure of between 63.4% and 71% according to the Commission. The Court found that, during the period at issue, *Wanadoo* "had a very high market share which, save in exceptional circumstances, proves that it had a dominant position within the meaning of the case-law cited above."[8]

A high market share may well indicate that a firm is dominant but it is arguable that a high market share over what was a relatively short period of time is insufficient to reach such conclusions.

The evidence before the Court indicated that *Wanadoo* and other providers had only launched their ADSL services on a commercial basis "at the end of 1999." Arguably there will be many instances involving new products where the firm that has developed the product will have a high market share just over a year after the product has been brought to market. Holding that such a firm is dominant because it retains such a high market share over a relatively short period of time seems excessive. Such a standard could have profound implications for firms launching new innovative products.

Matching Competitors' Prices.

Wanadoo had argued that the Commission decision questioned, what it claimed, was the right of very undertaking to align its prices in good faith, with those of its competitors. It further claimed that this right was established under EU case law.[9] The Court noted that the ECJ had not been required in *Akzo* to rule on whether it was lawful for a dominant firm to align its prices with a competitor where that resulted in pricing below cost. The Court went on:

> "It is therefore not possible to assert that the right of a dominant undertaking to align its prices on

[5] In this context the price-cost margin refers to the margin between price and marginal cost.
[6] *Hoffmann-La Roche* v *Commission* [1979] ECR 461
[7] It noted that *Wanadoo* had claimed that its market share fell to 63.6% in October 2002, although the Commission estimated it was between 63.4% and 71% at that time.
[8] Para 103.
[9] *AKZO* v *Commission* [1991] ECR I-3359.

> those of its competitors is absolute and that it has been recognised as such by the Commission in its previous decisions and in the relevant case-law, in particular where this right would in effect justify the use of predatory pricing otherwise prohibited under the Treaty."[10]

The Court then concluded:

> "Even if alignment of prices by a dominant undertaking on those of its competitors is not in itself abusive or objectionable, it might become so where it is aimed not only at protecting its interests but also at strengthening and abusing its dominant position."[11]

The finding that a dominant firm has no absolute right to match prices charged by its competitors and that it may not do so if such prices are predatory is an important one.

A "meeting competition" argument is an accepted defence against claims of predatory pricing in many jurisdictions. For example, dismissing Department of Justice proceedings alleging predatory pricing in the *American* Airlines case, a US Court held that there was no evidence that American Airlines had set prices below average variable cost and that it had simply matched, but not undercut, fares charged by low cost entrants.[12]

The justification for such a defence is that that it would be contrary to the purpose of competition law to force a company to maintain non-competitive prices, or that even dominant firms must be allowed to compete. The OECD has argued that such rationales beg the question of what is legitimate competition. They point out that a meeting competition defence may:

(a) Prevent far more efficient entrants from winning the customers they need to survive, as customers are unlikely to switch to a new entrant when there is no price saving, thus preventing the emergence of competition.
(b) Permit incumbents to build reputations as aggressive price-cutters who are willing to sustain losses in order to stave off entry.
(c) Enable the incumbent to match rivals' prices but offer a better quality product. Implicitly this amounts to undercutting rivals' prices but may be difficult to detect and prove.

The OECD therefore argues against allowing a "meeting competition" defence in predatory pricing cases.[13]

Recoupment.

A final interesting point raised by *France Telecom* was the question of recoupment. It argued that the Commission should have considered whether it was likely that *Wanadoo* would have been able to recoup the costs of predation in the future. It further argued that, if there was no possibility of ousting competitors, or at the very least, of hindering or restraining their conduct, then a predatory strategy could not be considered rational. The view that there must be a strong likelihood of recoupment has long been accepted in US cases on predatory pricing and was originally set out by the Supreme Court in the *Matsushita* case.[14]

[10] Para 182.
[11] Para 187.
[12] *US v. American Airlines, Inc. et al.* Judgment of 7.4.2001, US District Court for the District of Kansas, case no. No. 99-1180-JTM.
[13] OECD, *Preserving Competition: Keeping Competitors at Bay,* Policy Brief, December 2005.
[14] Matsushita Electric Industrial Co. Limited et al. v. Zenith Radio Corp. et al. 475 US 574.

Wanadoo's arguments were rejected by the Court which cited the ECJ judgement in *Tetra Pak.*

> "[I]t would not be appropriate, in the circumstances of the present case, to require in addition proof that Tetra Pak had a realistic chance of recouping its losses. It must be possible to penalize predatory pricing whenever there is a risk that competitors will be eliminated. The Court of First Instance found, at paragraphs 151 and 191 of its judgment, that there was such a risk in this case. The aim pursued, which is to maintain undistorted competition, rules out waiting until such a strategy leads to the actual elimination of competitors."[15]

The lack of a recoupment test constitutes a marked difference between the EU and US approach to predation. Some economists have argued that the US courts have set too high a standard for proof of recoupment in predation cases.[16] Nevertheless, the EU view, that there is no need to establish a likelihood of recoupment, may result in false findings of predation.

Conclusion.

The Court of First Instance judgment clarifies the extent and circumstances in which a dominant firm may respond to price cuts by rival firms. While it might seem to restrict the ability of dominant firms to respond competitively to price cutting by rivals, the rejection of an absolute right to match rivals prices seems justified from an economics perspective. Other aspects of the judgment are a little more troubling; in particular, the analysis of market definition, the reliance on high market shares over a relatively short period of time, and the rejection of any need to show that recoupment is likely in order to prove predatory pricing.

[15] *Tetra Pak* v *Commission* [1996] ECR I-5951, para 40.

[16] P. Bolton, J.F. Brodley and M. Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 1999.

UK Appeals Court Overturns Excessive Pricing Decision.

Introduction.
In a judgment delivered on 3rd February, the UK Court of Appeals overturned a High Court judgment which found that a firm had abused a dominant position by charging excessive prices to its customers. The High Court judgement, which was delivered last year, was the first case before the UK courts in which a firm was found to have abused a dominant position.

Background.
The case arose out of a dispute between the dedicated horse-racing channel, *At the Races* (*ATR*), and the *British Horse Racing Board* (*BHRB*) regarding the manner in which the latter body supplied and managed its pre-race data – the information on runners and riders which enables bookmakers to take bets on races.
The *BHRB* has an agreement with the *Press Association* (*PA*) for the supply of pre-race information. The *ATR* in-turn had an agreement with the *PA* under which it paid for the provision of pre-race data. The *BHRB* had demanded that *ATR* should enter into an additional licence agreement with it to pay for the database rights. The ECJ had held that the *BHRB* had no database rights. The *BHRB* nevertheless indicated that, unless *ATR* agreed to enter the licence agreement and pay licence fees, it would instruct the *PA* to terminate the supply of pre-race data to *ATR*. In 2006, the High Court found that the *BHRB*'s conduct amounted to an abuse of a dominant position.

The Appeal Court Judgment.
The Appeal Court overturned the earlier High Court judgment and held that the judge had erred in finding that the *BHRB* had abused its dominant position in the market for UK pre-race data. The Appeal Court stated:

> "The principle issue is excessive pricing. On that…our conclusion is that the judge erred in holding that the economic value of the pre-race data was the competitive price based on cost-plus.
> This method of ascertaining the economic value of this product is too narrow in that it does not take account, or sufficient account, of the value of the pre-race data to *ATR*, and in that it ties the costs allowable in cost-plus too closely to the costs of producing the pre-race data."

Comment.
The ECJ has, in the past, considered prices to be unfairly high when the economic value of the goods or services is well below the price charged for such goods or services.[17] It has indicated that economic value should be determined by the actual production and supply costs of the goods or services, or by reference to the prices for comparable goods.[18] In contrast to the EU position, excessive or monopoly pricing is not considered offensive under US law.
The Office of Fair Trading (OFT) addresses the question of monopoly

[17] Case 26/75 *General Motors v. Commission* [1975] ECR 1367.
[18] Case 27/76 *United Brands v. Commission* [1978] ECR 207.

pricing in its Guideline on *The Chapter II prohibition.*[19] It states that prices can be considered excessive if they allow undertakings to sustain greater profits than would otherwise occur in a competitive market – "supernormal profit". The Guidelines indicate that prices would not be considered abusive, if they occur for short periods within competitive markets, if they reflect superior efficiency, or if they occur in markets where there is innovation to improve products and/or processes.

It is interesting that the UK Court of Appeals in this case specifically rejected the idea that a cost-plus methodology could be employed to determine whether prices were excessive.

The question of excessive pricing raises a number of complex issues. Economists' opposition to monopolies stems from the fact that a monopoly will charge higher prices and produce a lower level of output than a competitive industry. The effect of this is to reduce overall welfare.

Economists are, however, generally opposed to the idea of using competition law to deal with "monopoly" or "excessive" pricing. This is largely because of the difficulties involved in deciding when exactly prices should be considered excessive. For example, how is the "competitive price" to be determined in a market where a firm has a dominant position and by how much should prices exceed the "competitive level" in order to be considered excessive? More generally the issue of *ex post* regulation of excessive prices under competition law may result in a firm being fined at some future point for charging a price that is deemed excessive. More fundamentally attacking excessive pricing would seem to constitute a form of *ex post* price regulation of dominant firms generally. Such regulation is inconsistent with the basic idea of having prices determined in competitive markets. There are exceptions in areas such as gas and electricity where regulation of dominant firms' prices is considered necessary. Such price regulation, however, generally involves a system of *ex ante* regulation. Even here, in many jurisdictions attempts have been made to promote greater competition in the market with *ex ante* price controls being seen as a temporary short-term measure designed to "hold the fort" pending the development of effective competition.

Conclusions.

In overruling last year's High Court judgment, the Court of Appeal appears to have adopted an approach closer to that of the US than the EU.

[19] OFT Guideline 402.

Energy Green Paper Shuns Competitive Reforms.

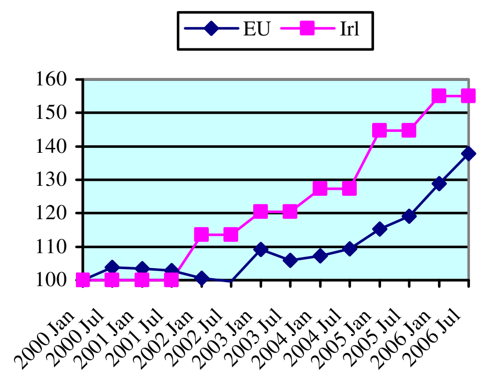
Introduction.

The Government initiated a consultation process on Irish energy policy with the publication of its Green Paper on Energy on 1st October 2006.[20] Submissions were sought in response to the Green Paper by 1st December.[21] Coinciding with the publication of the Green Paper, the Department of Communications, Marine and Natural Resources (DCMNR) published a detailed review on the future of the electricity in the industry which was carried out by Deloitte consultants.[22] The Deloitte Report provides a detailed analysis of the operations of the ESB and makes a strong case for a radical structural reform of the electricity industry in order to promote effective competition in that market. Unfortunately the Minister in his speech launching the Green Paper effectively ruled out implementing the Deloitte recommendations, which raises questions about the usefulness of the consultation process.

Irish Energy Prices are Excessive

Irish industrial electricity prices are among the highest in the EU, particularly for SMEs. Fig.1 shows how Irish industrial electricity prices increased much faster than the average for the EU 15 between mid 2001 and mid 2006. Irish electricity prices increased further in January. Recent months have also seen a number of major multinational firms warning that the high cost of energy in Ireland now constitutes a serious impediment to further investment.

Fig1: Irish v EU15 Industrial Electricity Prices
(Jan 2000 = 100)



Source: CSO and Eurostat

Ireland's high industrial electricity prices are due, in part, to our over dependence on gas for electricity generation which has meant that increases in World gas prices have contributed to Irish electricity prices rising faster than those in other EU Member States. Fig. 1 illustrates, however, that Irish industrial electricity prices were rising faster than those in other EU Member States, even before last year's rise in world gas prices. Other factors have contributed to Ireland's high electricity prices. The Deloitte Report estimated that excess costs and inefficiencies in the ESB add

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[20] Department of Communications, Marine and Natural Resources: *Towards A Sustainable Energy Future for Ireland.*

[21] Compecon prepared a response to the Green Paper on behalf of ISME, a copy of which may be viewed on the Department of Communications, Marine and Natural Resources website at http://www.dcmnr.gov.ie/NR/rdonlyres/54C78A1E-4E96-4E28-A77A-3226220DF2FC/27145/ISME.pdf

[22] Deloitte: *Review of the Electricity Sector in Ireland Final Report,* 9 December, 2005.

€100m to electricity prices. There is also evidence that gas transmission prices are higher in Ireland than in other EU Member States. This affects electricity prices because a high proportion of generation is gas fired.

Lack of Structural Reform has Hindered Competition.

The slow development of competition reflects the failure by successive Governments to undertake structural reforms of the electricity industry. There is considerable evidence from other jurisdictions that such restructuring is essential to promote vibrant competition and to ensure a successful transition from State owned monopoly to a vibrant competitive market. Where the incumbent operator owns or controls the transmission and distribution networks, it has an obvious incentive to obstruct entrants from accessing the grid. This problem can only be addressed by completely separating the transmission and distribution networks for gas and electricity from other parts of those industries. Various agencies including the Competition Authority, the Commission for Energy Regulation, the ESRI, the National Competitiveness Council and the OECD, together with numerous other studies have highlighted the fact that structural reform is essential in order to transform the electricity industry from a monopoly to a competitive industry. The Government has instead opted for transferring "control" of the grid to a separate body Eirgrid, while allowing the ESB to retain ownership. Irish business and consumers are paying a heavy price for the Government's failure to ensure an effective restructuring of the industry.

Structural Reform Vital.

The Deloitte report clearly recommended that the Government should implement a major structural reform of the ESB, involving the full separation of the transmission and distribution networks as well as the divestment of generation and supply portfolios by ESB. The Green Paper failed to include a clear commitment to implement the structural reforms recommended by the Deloitte Report, while the Minister in his speech launching the Green Paper appeared to rule out the Deloitte recommendation.

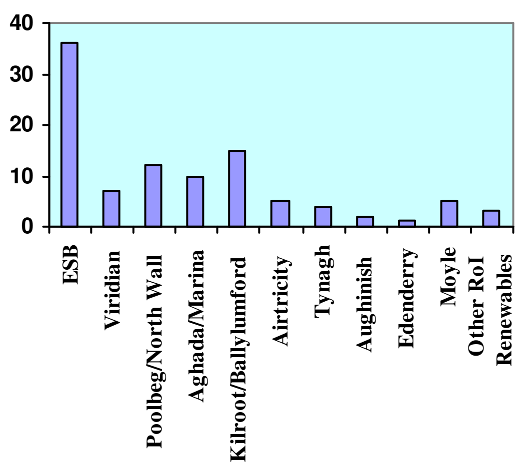
> "The Deloitte report makes a specific recommendation to fragment the ESB.
>
> The Government recognises the fundamental role played by ESB in the economic and social development of the State and the strategic value of maintaining the ESB as a strong and commercially viable company into the future.
>
> The retention of natural monopoly networks in State ownership is also a core policy tenet for the Government.
>
> The Government does not in any circumstances favour the fragmentation of the ESB. We believe such a move would not reduce prices, but could in fact increase them and endanger our security of supply and competitiveness."[23]

The Minister's claim that the Deloitte report made a specific recommendation to fragment the ESB seems somewhat exaggerated. The report recommended the transfer of the monopoly networks to a separate State body and the divestment of some generating plants and some

[23] Speech by Mr. Noel Dempsey T.D, Minister for Communications Marine and Natural Resources at the launch of the Green Paper Towards A Sustainable Energy Future for Ireland, in the Government Press Centre, Government Buildings, Sunday, 1 October 2006.

supply portfolios. The Deloitte Report made clear that this would involve the retention of a strong ESB which would operate as an integrated generation and supply business. Fig.2 shows that even under the proposed divestment, ESB would remain by far the largest electricity generator with 36% of total generation capacity in the proposed all Ireland electricity market.

Fig. 2: Structure of All Ireland Electricity Generation Market under Deloitte Proposals (%)



It seems strange that the Minister should specifically rule out the recommendations of the Deloitte Report at the outset of the consultation process. The Minister's suggestion that the creation of a landbank of generation sites, which was only one element of the Deloitte recommendation, will on its own suffice to create competition in generation is highly questionable. In rejecting proper structural reform, the Minister is not only rejecting the recommendations of his own consultants but of numerous other reports all of which have stated unambiguously that competition in the electricity market will only come about by implementing wide ranging structural reforms. It is the lack of such reforms which has prevented the development of competition up to now and which has directly contributed to Ireland's high level of electricity prices.

Regulatory Reform also Required.

The Green Paper did not consider the regulatory regime for gas and electricity stating that this has been deferred until the completion of the all Ireland single electricity market. This is unfortunate. The Deloitte finding that inefficiencies and excess costs are adding €100m to Irish electricity prices is a serious indictment of the current regulatory regime. Regulatory arrangements for the gas and electricity arrangements need to be reviewed as a matter of urgency.

Conclusion.

The Green Paper states that the Government is committed to opening up the gas and electricity markets to competition. It is time to demonstrate that commitment by accepting and implementing the preferred recommendations of the Deloitte report. The cost to the economy of failing to grasp the nettle of competitive reform will be considerable in terms of jobs lost in many small and medium enterprises and the potential damage to Ireland's attractiveness as a location for major foreign direct investment.