Pricing Issues under EC Competition Law with a special focus on the Postal Sector

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Pricing – The “core” of Competition Law

Ronald Coase [1991 Nobel Prize in economics] said he was tired of competition law because “when the prices went up the judges said it was monopoly, when the prices went down they said it was predatory pricing, and when they stayed the same they said it was tacit collusion”

Source: William Landes in "The Fire of Truth: A Remembrance of Law and Econ at Chicago", JLE (1981) p.193.

Pricing Cases - Increasing Importance in Network Industries

- A significant number of the recent competition cases in the field of network industries concern pricing issues:
  - ✓ *De Post-La Poste/Hays (2001)*;
  - ✓ *Deutsche Post I (2001/354)* and *II (2001/892)*;
  - ✓ *Deutsche Telekom (2003)*;
  - ✓ *Wanadoo Interactive (2003)*;
  - ✓ *BdKEP/Deutsche Post AG and Bundesrepublik Deutschland (2004)*
- The issue is, however, not new. Already in its 1998 Notice on the application of the competition rules to the postal sector, the Commission insisted on the importance of competitive pricing for postal services (See recitals in preamble).

A Two-Tier Approach to Pricing in Network Industries

- **First tier – *ex ante* sector specific regulation:** wholesale and retail prices may be subject to regulatory oversight
- **Second tier – *ex post* EC competition law:** prices are occasionally subject to regulatory intervention. Besides anti-cartel provisions (Article 81 EC), dominant firms' pricing policies are subject to the prohibition of abuse of a dominant position contained in Article 82 EC

I. Price Regulation

- In the absence of a sufficient degree of competition, postal regulators may decide to impose price controls at the:
  - Upstream level (access pricing)
  - Downstream level (retail pricing)
- A variety of methodologies can be relied upon to control prices (price-cap, rate of return, etc.). Price control generates significant debate which kinds of costs should be taken into account.

II. EC Competition Law

A. Excessive pricing
B. Predatory pricing
C. Rebates
D. Margin squeeze
E. Price Discrimination

Important Concepts

- Article 82 EC prohibits both **exploitative** and **exclusionary** pricing conducts:
  - ✓ "Exploitative" conduct: pricing practices that result in a direct loss of consumer welfare. The dominant firm takes advantage of its market power to extract rents from customers that could not have been obtained by a non dominant firm
  - ✓ "Exclusionary" conduct: pricing practices directed against rivals that indirectly cause a loss to consumer welfare by limiting the rivals' ability to compete (e.g. predatory pricing)

Business practice	Harmful economic effect	Legal qualification
High prices	Customers exploitation	Excessive pricing Art. 82(a)
Low prices	Competitors exclusion	Predatory pricing and abusive rebates Art. 82(b)
High prices (wholesale) + low prices (retail)	Downstream competitors exclusion	Abusive margin squeeze Art. 82 (b)
Differentiated prices	Customers exclusion	Price discrimination Art 82(c)

A. Excessive (or "unfair") pricing under Article 82 EC

- Originality of EC competition law. Other competition law regimes have chosen to "trust" the market: high prices are short lived as they trigger entry of new firms. In the long run, high prices lead to increased competition in the market place

- Enforcement limited to exceptional circumstances:
  1. Typically in exorbitant situations where price exceed at least from 100% the costs of the dominant firm. A price simply in excess of the competitive level will not trigger intervention
  2. Cases often involving a market partitioning problem (see the *United Brands*, *General Motors*, *British Leyland* cases)
  3. Lately, the Commission has promoted a restrictive stance to claims of excessive pricing (see the *Port of Helsinborg* case)

Excessive pricing – Legal Standard

- **Definition**: “[c]harging a price which is excessive because it has no reasonable relation to the economic value of the product supplied” (*United Brands*);
- **Test**: “determine whether the difference between the costs actually incurred and the price actually charged is excessive; and if the answer […] is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products”;
- **Commission’s practice**: four methods have been used (i) price-cost margin analysis; (ii) price comparisons accross markets or competitors; (iii) geographic price comparisons; (iv) comparisons over time.

Excessive Pricing in the Postal Sector – The *Deutsche Post II* case

- Allegation that DP has abused its dominant position by charging an excessive price for the delivery of incoming international mail. DP Post classifies IIM as circumvented domestic mail and charges the full domestic tariff (0,56 €).
- Commission confronted with an "information" problem
  - ✓ No cost benchmark available in a monopolistic market: "In a market which is open to competition the normal test to be applied would be to compare the price of the dominant operator with the prices charged by competitors. Due to the existence of DPAG's wide-ranging monopoly, such a price comparison is not possible in the present case";
  - ✓ No reliable information on costs: DP had not set a "transparent, internal cost accounting system and no reliable data exist for the period of time relevant to this case".
- The Commission assesses the costs on the basis of a proxy: DP had argued in the past that the average cost for the delivery of international mail could be approximated to 80% of the domestic tariff (see *REIMS II* notification). Other operators say it is up to 70% of the domestic tariff;
- By charging the full domestic tariff (0,56€) for delivery of international mail, DP has exceeded by +/– 25% the economic value of the service (0,45€);
- Importantly, the Commission indicates that an excess of only 25% may be deemed abusive by virtue of the facts that (i) DP is a monopolist and; (ii) of the special features of the postal sector (*e.g.* liberalization policy initiatives).

B. Predatory Pricing under Article 82 EC

- Predatory pricing is a deliberate strategy by a dominant firm of setting very low prices to drive its competitors out of the market. Once the predator has successfully excluded existing competitors and deterred entry of new firms, it can raise prices and earn higher profits
- Leading cases are *AKZO* and recently, in the telecommunications sector, *Wanadoo Interactive*
- In the postal sector, predatory pricing is often sustained through "cross-subsidization". A situation of this kind arises when a multi-services dominant firm allocates the majority of its costs to its reserved monopolistic activities. It can subsequently set its prices at very low levels on the competitive markets.

Predatory pricing – Legal Standard

- Question turns on an examination of the costs benchmarks set out in *AKZO* and *Wanadoo*
  - ✓ if the dominant firm prices are set <u>below Average Variable Costs (AVC)</u>, unlawful predation is **presumed**. Pricing below AVC has no economic rationale other than the elimination of competitors, since every unit sold is a net financial loss
  - ✓ If the dominant firm's prices are set <u>above AVC but below Average Total Costs (ATC)</u>, unlawful predation can only be established on the basis of **additional evidence**. Firms may, in certain circumstances, rationally price above AVC and below ATC, as it still allows the recovery of a share of their fixed costs. As predation is not the sole economic rationale for such a pricing policy, competition authorities are required to produce additional elements of proof: prices below ATC "will be regarded abusive if they are determined as part of a plan for eliminating a competitor"

A Different Cost Standard for Network Industries?

- Some economists consider that using the Long Run Incremental Costs ("LRAIC") benchmark would be better suited:
  - ✓ In sectors with **high fixed costs and low variable costs** a price may well equate with AVC – and thus not be *prima facie* predatory – and still be substantially lower than the price the firm needs to cover the cost of supplying its products and thus be *de facto* predatory. To address the problem, the Commission has suggested the use of a LRAIC benchmark. The LRAIC covers all the costs incremental to the production of the product at hand, including fixed and variable costs.
  - ✓ In sectors where **dominant firms sell more than one product/service**. A difficult issue is how to allocate fixed and variable costs that are incurred in common with two or more products. A solution often supported by economists is to ignore the common costs, and focus only on the costs that are incremental to the production of the specific service at hand.

The *Deutsche Post I* case (1)

- **Issue**: It was alleged that Deutsche Post charged below costs prices in the business parcel delivery market and funded the losses incurred in this market by a cross-subsidy from the reserved monopoly letter business;

- **Methodology applied by the Commission**: LRAIC benchmark. The Commission excluded from the costs, the various common costs that would have in any event been incurred by the reserved monopoly activities. It only considered DP's incremental costs of providing the parcel service.

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The *Deutsche Post I* case

- **Commission's findings:** "[i]n the period 1990 to 1995 every sale by DPAG in the mail-order parcel services business represented a loss which comprises all the capacity-maintenance costs and at least part of the additional costs of providing the service. In such circumstances, every additional sale not only entailed the loss of at least part of these additional costs, but made no contribution towards covering the carrier's capacity-maintenance costs. In the medium term, such a pricing policy is not in the carrier's own economic interest. This being so, DPAG had no economic interest in offering such a service in the medium term. DPAG could increase its overall result by either raising prices to cover the additional costs of providing the service or — where there is no demand for this service at a higher price — to discontinue providing the service, because revenue gained from its provision is below the additional costs incurred in providing it."
- **Remedy:** importantly, in *Deutsche Post AG*, the firm undertook to structurally separate the mail order business from the letter business activities.

Can Above Cost Pricing be Abusive?

- Price cuts above ATC are in principle not predatory, as they can only lead to the exclusion of less efficient competitors only or deter inefficient entrants
- Yet, the case-law and the Commission's decisional practice recognize that in "exceptional circumstances" dominant firms may breach Article 82 EC for selectively undercutting the prices charged to certain customers by competitors, with a view to excluding or deterring the entry of such competitors
- The Discussion Paper indicates that "exceptional circumstances" will arise where the dominant firm has certain **non-replicable advantages or where economies of scale are very important and entrants necessarily will have to operate for an initial period at a significant cost disadvantage**. Because entry can practically only take place below the minimum efficient scale. This factor could be relevant for network industries and the postal sector
- Commission has stressed that an abuse will only be found in situations where the price cuts have lead or will lead to "substantial" consumer harm

C. Rebates under Article 82 EC

- Rebates are discounts from the standard price paid to the buyer after the transaction. A distinction is generally drawn between two types of rebates:
  - ✓**Unconditional rebates**, *i.e.* those granted to certain specific customers - and not to others - independently of their purchasing behaviour;
  - ✓**Conditional rebates**, *i.e.* those granted to certain customers in exchange for a specific purchasing behaviour.

Rebates – Legal standard (1)

- **Unconditional rebates** are only problematic where used as a predation means: the dominant firm selectively eliminates key sources of demand for actual and potential competitors to prevent market entry. The Commission applies the framework applicable to predatory pricing.
- **Conditional Rebates** are generally problematic. A further distinction is drawn between incremental rebates (only bear on purchases above the threshold), that have a lesser anticompetitive effect than "all-unit" rebates (bearing on all purchases achieved during the reference period).

Rebates – Legal Standard (2)

- **Strict approach to All-unit rebates.** They produce a **"suction effect"** by virtue of the fact that reaching the target awards a discount on all units purchased up to that point and not only on purchases above the target. This is problematic when one firm dominates the market: the rebates have the effect of pre-empting a share of the market that may be critical for rivals' and new entrants' abilities to compete with the dominant firm. In discouraging customers from placing orders with rival producers, all unit rebates are said to be **"fidelity-building"**. In the past ***per se*** prohibited. The Commission's discussion paper however promotes a **rule of reason** approach (assessment of the market share covered by the rebates, size of the rebates, level of the threshold, duration of the reference period, etc.)

- **More lenient approach to unconditional and incremental rebates.** Dominant firms can put forward convincing objective justifications and/or efficiency reasons in response to allegations of abusive unconditional rebates. In particular, dominant suppliers' unconditional rebates schemes often serve efficiency-enhancing purposes, such as enlarging the customer base to maximize fixed-cost recovery. Firms facing large fixed costs such as firms in the postal sector can offer unconditional rebates to expand their output and thus spread fixed costs over a large number of units.

Fidelity Rebates in the Postal Sector – *Deutsche Post I*

Facts: *Deutsche Post* implemented a long-standing scheme of fidelity rebates in mail order parcel deliveries. The Commission's investigation revealed that from 1974 through 2000, DP gave substantial discounts to its large customers on the condition that the customer sent its entire mail-order parcel business or at least a sizeable proportion thereof via DPAG:

Findings:

> §39 "The systematic agreeing of fidelity rebates with cooperation partners leads, according to the case-law of the European courts, inevitably to the conclusion that DPAG is seeking to tie customers to it and hence is preventing or eliminating competition. It is settled European case-law that rebate arrangements which are linked to meeting a percentage of customer requirements have, solely by reason of the method by which they are calculated, an anti-competitive tying effect. Customers who have entered into such a rebate agreement will generally be inclined to have their parcels distributed exclusively by the company giving that rebate. Rebate arrangements linked to a percentage of customer equipments, moreover, owing to the method by which they are calculated, have an obstructive effect that is not linked to anything actually performed. This can be seen by the fact that competitors are compelled to offer discounts to offset the loss which customers suffer if they have a smaller percentage of their parcels distributed by DPAG and hence fall into a lower rebate bracket".

The fidelity rebate scheme has precluded competitors from reaching the "critical mass" to successfully enter the German mail-order delivery market. Between 1990 through 1999 DP had a stable volume-based share of the mail-order parcel market exceeding 85%. The Commission imposed a 24 million € fine.

Other forms of Anticompetitive Rebates – The *De Post/Hays* Case

- The Belgian postal operator De Post La Poste offered a “preferential tariff” for the general letter mail service subject to the acceptance of a supplementary contract covering a new business-to-business ("B2B") mail service
- Hays, a competitor active on the B2B document exchange network market, could not compete with the tariff reduction offered by La Poste in the monopoly area and was losing most of its clients in Belgium
- By tying the tariff reduction in the monopoly area to the subscription of its B2B service, La Poste made it impossible for Hays to compete on a level playing field because it could not offer a similar advantage
- Form of **bundled rebates/financial tying** typically prohibited under Article 82(d).

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D. Margin Squeeze under Article 82 EC

- **Definition:** a margin squeeze involves situations in which a vertically integrated dominant firm hampers downstream rivals' competitiveness in (i) raising the wholesale price of its essential input and/or (ii) reducing the retail price of the product/service;
- **Case-law and decisional practice:**
  - ✓ Scarcity of cases: *National Carbonising*, *British Sugar, Industrie des poudres sphériques*;
  - ✓ Particularly relevant in network industries sectors, where incumbent holding essential "facilities" have also engaged into downwards integration. See e.g. the *Deutsche Telekom* case, 2003 (discussed below).

Margin Squeeze – Legal Standard

- **Legal standard:** See Commission's Notice on access agreements in the telecommunications sector at §§117-118:

  "A price squeeze could be demonstrated by showing that the dominant company's own down stream operations could not trade profitably on the basis of the upstream price charged to its competitors by the upstream operating arm of the dominant company. [...] In appropriate circumstances, a price squeeze could also be demonstrated by showing that the margin between the price charged to competitors on the downstream market (including the dominant company's own downstream operations, if any) for access and the price which the network operator charges in the downstream market is insufficient to allow a reasonably efficient service provider in the downstream market to obtain a normal profit (unless the dominant company can show that its downstream operation is exceptionally efficient)"
- **Four conditions:** (i) input supplier is vertically integrated; (ii) input is essential; (iii) the price charged would prevent an efficient competitor from making a normal profit; (iv) there is no objective justification for this pricing strategy;
- **Alternative test?** In *Deutsche Telekom*, the Commission applied a slightly different test. It tried to determine what would have happened had DT applied the same input price to its own downstream operations.

Margin Squeeze – Other Issues

- Incentives to engage into margin squeeze is not clearcut. Trade-off for a dominant input supplier:

  Limitation of downstream competition vs. loss of upstream revenues

- Scope for conflicts with sector specific rules in network industries where both wholesale and retail price may be subject to regulatory control (see below)
- For more, see Geradin & O'Donoghue, 2005

E. Price Discrimination under Article 82 EC

- Price discrimination occurs whenever two sales of the same product/service produce two different rates of return, i.e. when the ratio of price to marginal cost is different for one sale than it is for the other.
- *Summa divisio* between:
  - ✓ **« Primary line injury » price discrimination** occasioned by the dominant firm to its competitors by applying different prices to its own customers (not different from rebates, for instance);
  - ✓ **« Secondary line injury » price discrimination** which is imposed on one of several customers of the dominant firm as against one or several other customers.
- Article 82(c) is mainly concerned with secondary line price discrimination. See Geradin & Petit, 2006.

Price discrimination

- It is only in limited circumstances that a <u>non-vertically integrated firm</u> has the incentives to engage in secondary line injury price discrimination
- More frequent circumstances where a <u>vertically integrated firm</u> will engage into secondary line injury price discrimination. Price discriminating in favour of ones' downstream subsidiaries inflicts a competitive disadvantage to the subsidiaries' rivals. A monopolist in an input market has a strong incentive to increase the costs of the rivals to its downstream subsidiary as this "softens" downstream competition and increases its profits;
- **Price discrimination is thus relevant in network industries**, where incumbent operators are active on both upstream and downstream levels.

Price Discrimination – Legal Standard

- **First condition:** applying dissimilar prices to “equivalent transactions”
  - ✓ Often uneasy to determine whether transactions are equivalent. Most obvious reason for stating that two transactions are not equivalent is that the sales involve different costs for the seller. The problem is of course to determine how significant cost differences should be for two transactions to be considered non-equivalent
  - ✓ European commission generally assume that transactions are equivalent without much analysis
- **Second condition:** the dominant firm’s trading parties must be placed at a competitive disadvantage against others
  - ✓ Need to identify a downstream relevant market;
  - ✓ Need to show a distorsion of competition on that market
  - ✓ European Commission generally ignores these conditions

The *BdKEP/Deutsche Post AG* Case

- The German Postal Law contained provisions which had the effect of allowing large senders to feed self-prepared mail directly into sorting centres and enjoy discounts for doing so, while commercial mail preparation firms were denied the right to enjoy similar discounts.

- As a result of these provisions, DP was applying dissimilar conditions to equivalent transactions because large senders and commercial firms handling over similar volumes of prepared mail at sorting centres paid different tariffs. The Commission considered that the German Postal Law provisions induced Deutsche Post AG to engage in price discrimination contrary to Article 82(c).

- Secondary line competitive injury resulting from this practice not manifest:
  - ✓ Commercial mail preparation firms and large senders are not competing on a relevant market;
  - ✓ Commission nonetheless managed to identify a secondary line injury element in DP’s conduct. As DP had launched two mail preparation services to large senders, it was thus active at the same level as commercial preparation firms. By virtue of the discriminatory discounts conditions, the failure of mail preparation firms to qualify for quantity-based discounts put those firms at a competitive disadvantage vis-à-vis DP.

III. The « Dangerous Liaisons » of Sector Specific Regulation and Competition Law

- On some occasions, the intervention of a regulatory authority fails to eradicate concerns of anticompetitive pricing;
- As seen previously, Article 82 EC covers a wide range of pricing policies. Competition authorities may thus be tempted to « step in » so as to eliminate the anticompetitive pricing situation. Article 82 EC is a Treaty provision which prevails over sector specific regulation.

An Empirical Example – The *Deutsche Telekom* Case (1)

- ✓ Prices charged by DT to its competitors for access to LL
- ✓ Approval of Tariffs by German Telecoms regulator (RegTP) from 1998-2002
- ✓ Complaint by competitors (margin squeeze) before the Commission in 1999
- ✓ Commission open 82 EC procedure in 2002

The *Deutsche Telekom* Case (2)

- DT argued that its conduct could not be held as an infringement of Article 82 EC in that its tariffs had previously been approved by the German telecommunications regulator, the RegTP. DT considered that if there was a violation of EC law, the appropriate course of action was the initiation of Article 226 EC infringement proceedings against Germany in spite of a direct procedure against the undertakings' whose rates had been approved by the regulator.

- DT's arguments were rebutted by the Commission: "the competition rules may apply where the sector specific legislation does not preclude the undertakings it governs from engaging in autonomous conduct that prevents, restricts or distort competition".

- The Commission observed that the charges for wholesale and retail access to the loop were regulated but that DT was still left with a commercial discretion which allowed it to restructure its tariffs in order to put an end to the margin squeeze. DT could have avoided the price squeeze by increasing the retail charges, which DT actually did but in insufficient volumes.

- DT's behaviour was the main source of the restriction of competition and that Article 82 EC was the appropriate course of action. DT was condemned to a € 12.6 million fine. The previous application of a regulatory remedy was merely taken into account as a mitigating factor for the calculation of the fine.

Pros and Cons of Competition Authorities Pricing Intervention in Network Industries

PROS	CONS
•Safety net	•Increase in transaction costs for operators; •Increase in legal uncertainty for operators; •Risk of disproportionate remedies through the sequential intervention of different institutions; •Competition authorities lack sufficient expertise and information to engage into pricing analysis; •Duplication of resources and additional burden on competition authorities; •Risks of multiple proceedings before courts and NCAs, as EC competition provisions can be applied by a plethora of enforcers; •Risk of procedural abuses by competitors

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