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# Introduction

Exclusionary practices are contracts, pricing strategies and more generally actions taken by dominant firms to deter new competitors from entering an industry, to oblige rivals to exit, to confine them to market niches, or to prevent them from expanding, and which ultimately cause consumer harm. This is certainly the most controversial area in competition policy, and one in which economics has arguably not yet been able to guide policymakers in the design of sensible rules and enforcement practices.

Whether due to the influence of the Chicago School (in whose teaching there is little room for the possibility that dominant firms exclude rivals in a welfare-detrimental way) or due to other reasons (such as the expectation that entry will take place, hence reducing any existing market power), it is rare for US courts to find that a firm has infringed antitrust laws on the basis of monopolisation or attempted monopolisation.[1] In general, therefore, even firms with very significant market power are free to engage in unilateral business practices such as tying, exclusive dealing contracts, fidelity discounts and aggressive price policies (obviously, this lenient stance does not extend to coordinated behaviour such as cartels, which is punished very severely).

[1] Administrability may also have contributed to a more laissez-faire approach in dealing with exclusionary practices in the US. Indeed, Kovacic (2007) argues that it is the combined effect of the Chicago School (stressing that it was unlikely that certain practices would be anti-competitive) and of the Harvard School (calling for simple rules in order to make competition law easy to administer) that has led to a conservative stance in monopolisation cases. Note, however, that administrability may equally support simple rules in the other direction. In the EU, for instance, one often hears voices calling for blanket prohibitions of practices such as exclusive dealing and loyalty rebates since a more nuanced approach would be too complex for lawyers and judges to administer.



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At the other extreme, dominant firms in the European Union ('EU') are under close scrutiny,[2] and it is very unlikely that cases involving practices such as exclusive dealing, fidelity rebates and price discrimination are decided in favour of a dominant firm.[3]

Most economists have denounced this state of affairs as unsatisfactory for quite some time[4] and have emphasised that these practices may be anti-competitive or efficiency-enhancing depending on the circumstances. As a consequence, they should be neither under a (*de jure* or *de facto*) *per se* illegality nor under a laissez-faire regime, but should be assessed on the basis of the effects exerted on the market. Admittedly though, the guidance that economic theory has so far been able to provide to competition law enforcement in this area is not fully adequate. Some so-called post-Chicago models have offered what economists call 'possibility results' (namely, the development of models showing that a given practice *may* have an anti-competitive effect under certain conditions), but few 'general identification' results, which could assist the analyst in uncovering all the potential effects (positive and negative) of an exclusionary practice, as well as their significance in practice. Note also that such issues are extremely important for a modern economy, because wrong policies in this area can have welfare-detrimental effects either by eliminating competition (a hands-off approach would allow incumbent firms to exclude new or small efficient rivals, thereby leading to persistent dominant positions) or, at the other extreme, by impeding practices which lead to lower prices or higher investments (think of interventionist policies which prevent dominant firms from offering good deals, or from introducing new products, or from using contracts which may promote investments).

The objective of this book is to deal precisely with these issues, by developing a general analytical framework which encompasses and extends previous works, and by identifying clear and workable criteria that can help competition authorities in dealing with exclusionary practices. Indeed, an economics-based approach need not be a case-by-case approach, and it is important to find workable rules which allow competition authorities and

[2] Under EU law, a dominant firm has a special responsibility not to allow its behaviour to impair genuine, undistorted competition on the internal market.

[3] The European approach has certainly been influenced by the so-called 'ordo-liberalism', a doctrine developed in Germany in the first half of the twentieth century, and according to which the law should protect the market from both ('unfair') distortions by public power (government) and by private economic power (large firms). See Amato (1997) for a discussion of the origin of competition law in both the US and the EU.

[4] See in particular Vickers (2007).

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courts to administer the law in a clear and predictable way, consistently with the principle of legal certainty.

## Exclusion: a general analytical framework

There is by now a large body of economic models providing examples of why and how a dominant firm may exclude rivals in a welfare-detrimental way. In this book, we show that many of these models of exclusionary conduct are particular instances of a common mechanism, which hinges on the existence of scale economies and incumbency advantages (that is, an asymmetry between the dominant firm and the rival(s), for example in terms of established customer base, investment in a key infrastructure, exploitation of scale economies) that are found in a variety of industries. Where scale economies exist,[5] a firm intending to challenge the dominant incumbent firm needs to attain a certain scale to be profitable. In turn, this means that if the dominant firm induces enough buyers to buy from it, the entrant will be deprived of the scale it needs and will refrain from entering or from expanding its operations beyond some market niche, or it will be obliged to cease operations. This will leave the dominant firm free to exercise monopoly power upon the remaining buyers and to recoup the loss (if any) it may have incurred while attracting the critical mass of customers away from the entrant. In this framework, there are different ways in which a dominant firm may attract buyers, for example: pricing below costs to some early buyers or markets, or to some large customers, engaging in exclusive dealing contracts with customers, tying a monopolised good to another good produced also by rivals, and refusing to deal with a competitor. By adopting this general framework, the book analyses a number of practices which may lead to exclusionary effects, and identifies under which conditions these practices are likelier to generate anti-competitive effects. This book shall also deal with exclusionary models other than the above-mentioned mechanism based on scale economies, with the aim of offering a more complete treatment of exclusionary practices; as well as policy implications which are sufficiently general and well grounded in order to provide some guidance to competition authorities and courts.

[5] As will be emphasised throughout the book, such economies of scale may arise on the supply-side, for instance due to fixed costs or minimum efficient scale of production; or on the demand-side, for instance due to externalities among users such as in network and two-sided markets.

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Specifically, this book analyses different practices across five chapters: Chapter 1 examines predatory pricing; Chapter 2 selective discounts (rebates) and other forms of price discrimination; Chapter 3 exclusive dealing; Chapter 4 tying and bundling; and Chapter 5 practices which may lead to vertical foreclosure, such as refusal to deal, denial of interoperability and margin squeeze.

## Some policy considerations

### Possession *versus* abuse of a dominant position

Competition laws in most jurisdictions do not prevent firms from obtaining or possessing a dominant position;[6] what they do prohibit is that a dominant firm abuses its market position by preventing rivals from contesting its dominant position, thus hindering the good functioning of a market. This is notably the legal approach in the EU (see Article 102 of the Treaty of Lisbon on the Functioning of the European Union) and in the US (Section 2 of the Sherman Act),[7] which have influenced most of the competition laws around the world. The principle that obtaining or possessing a dominant position is not by itself a problem is very important: it reflects the idea that it is the prospect of earning profits and market power which represents the engine of innovation and growth. Firms will innovate, invest, introduce new and higher quality products to be better

[6] In the EU, the Court of Justice defined dominance as a 'position of economic strength [...] giving [a firm] the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers' (*United Brands*, para. 65). This legal definition relates to the economic concept of market power (the ability to set prices above marginal costs), in that the case-law will find dominance whenever the firm at issue enjoys substantial market power.

[7] To be precise, the US Sherman Act does not use the 'abuse of dominance' terminology, in that it states: 'Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony'. However, in practice, like in the EU, for a potentially exclusionary conduct to be found a violation of US antitrust law, there must be in addition to the possession of monopoly power (which by and large is a similar concept to dominance) 'the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident', as noted by the Supreme Court (see *Grinnell*, para. 570–71).

The main difference between the two jurisdictions is that the EU also condemns exploitative abuses (which may be thought of as unfair ways to exercise a dominant position), such as excessive prices, whereas the US does not. This book does not deal with exploitative abuses, but only with exclusionary ones. On the former, the interested reader may refer to Motta and de Streel (2007).

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than rivals, be preferred by customers and hence earn higher profits.[8] If in this process there is a firm which is doing so much better than the rivals that it will dominate the market, that should be accepted (some would say welcomed) – so long as there has been ‘competition on the merits’ and the firm has not resorted to unlawful means.[9]

If competition laws followed a different approach and found it illegal to *hold* a dominant position, then the competitive process would not work properly: knowing that it will not be allowed to earn high profits, a firm would have significantly weaker (if any) incentives to invest, innovate or introduce new products or new business models. In turn, customers (and final consumers) would not be able to enjoy new and better products or benefit from innovations, and the whole economy would suffer from lower efficiency levels. The principle that the firm’s incentives (that is, the prospect of earning high profits) should be preserved will be behind most of our policy discussions on how to treat certain practices. For instance, we shall argue in Chapter 5 that competition authorities should impose mandatory access to an input (for example, a technology or an infrastructure) belonging to a dominant firm only under exceptional circumstances.

### The trade-off between intervening too much and too little

While there is probably consensus around the world that competition laws should not be designed or enforced to sanction the possession of a dominant position, but only its abuse, what actually determines an abuse and how competition authorities and courts should identify it, are clearly the most crucial and debated questions – and the main topic of this book. From the point of view of the case-law, it is fair to say – as we mentioned at the beginning of these introductory pages – that an infringement finding will be more likely in the EU than in the US, all else equal. In other words, in the EU (and in some jurisdictions around the world that have modelled

[8] See also the US Supreme Court in *Trinko*: ‘The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices – at least for a short period – is what attracts “business acumen” in the first place; it induces risk taking that produces innovation and economic growth. To safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive conduct.’ (Part III of the Opinion)

[9] In practice, the distinction between fierce – but fair or lawful – competition and unfair or unlawful competition can be difficult to make, as will be evident throughout the book (see also below in this introduction). One of our key objectives in this book is to provide guidance on how to make this distinction.

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their competition laws after the EU version) there are more restrictions on the practices that a dominant firm can engage into than in the US. In the same vein, we feel that in the EU there has been, at times, the temptation to protect competitors rather than the competitive process, whereas in the US there is probably too much faith in the ability of the market to heal itself. Let us explain why we think both extremes are mistaken.

Empirical evidence shows that competition promotes efficiency and productivity growth mainly through a selection process.[10] Absent rivalry, for instance in industries characterised by legal monopolies or where collusion is allowed, most firms would survive even if they are inefficient. When firms have to compete, instead, it will be those with good business ideas, which are well run and which continuously invest and improve their products and services, which will be successful and will grow. Whereas the least efficient ones – those which are badly managed, do not want to risk their capital, or quite simply have less appealing ideas or products – will have to downsize and might eventually have to shut down. This Darwinian process is the main source of productivity gains in an economy. But for this selection process to work, the market has to work well, and both entry and exit must be viable. In this light, neither an approach, which aims at protecting competitors, nor a laissez-faire approach, would serve the public interest.

If a competition authority is too prone to defend the rivals of a dominant firm even when the latter is competing on the merits, economic efficiency will not be promoted. Exit of inefficient firms is and should be part of the normal competitive process, and only too often do we forget that protecting inefficient competitors will have repercussions: the most efficient firms will not be able to take full advantage of their innovations, investments or business ideas, or will be dissuaded from offering pro-competitive price cuts, thus hindering the competitive process. A corollary of this approach is that competition authorities and courts should avoid protecting inefficient firms. By way of examples, in Chapters 1 and 2 we suggest that – when investigating a dominant firm for alleged exclusionary prices – competition authorities should adopt a safe harbour and find in its favour whenever its price is above an appropriate cost measure unless exceptional circumstances arise.[11] Otherwise, there would

[10] See, for example, the surveys by Bartelsman and Doms (2000) and Syverson (2011).
[11] See, for example, the US Court of Appeals' judgment in *Barry Wright* (a case concerned with the allegedly predatory nature of prices that were above costs): '[W]e believe that [...] above-cost price cuts are typically sustainable; that they are normally desirable (particularly in concentrated industries); that the "disciplinary cut" is difficult

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be the risk of protecting rivals which are inefficient (that is, they are unable to meet the incumbent's prices just because they have too high costs), and of chilling competition. In Chapter 3, we stress that – although potentially anti-competitive – an exclusive dealing contract with a buyer may also in principle lead to efficiency gains, for example where it protects investments made by the dominant firm in the specific relationship with that buyer. In Chapter 4, we caution against treating tying under a *per se* prohibition, because many innovations take place precisely by tying two previously separate components or products into a single one. Tying may well harm competitors in the markets at issue, but as long as consumers are benefiting from a genuine innovation, it would be difficult to conclude that the practice is anti-competitive.

On the other hand, while we believe that markets tend to function reasonably well, we should recognise that they can be (to a larger or smaller degree) imperfect: for example because of industry features such as very large fixed costs, sunk costs, switching costs or network effects; because of government regulations which raise legal barriers to entry; because of imperfect financial markets which make it difficult for young firms and potential entrants to obtain funds for a potentially good project. As a result, it may not be easy for rivals to compete effectively and contest the market position that a dominant firm has obtained in the past. In some circumstances, the market may not function well even absent particular strategic conduct by a dominant firm. If so, in some cases the correct response to a market failure may be the establishment of a regulatory regime. In other cases, a competition authority should remain vigilant and ensure that there is no conduct that the dominant firm resorts to in order to exclude rivals anti-competitively and cause harm to final consumers. This is because even practices which may appear to have limited effects if carried out by a non-dominant firm may actually have a significant impact if undertaken by a dominant firm. This appears to be the principle underpinning the existence of abuse of dominance provisions. As economists, we would add – as we explain throughout this book with reference to economic models – that the *degree* of dominance often goes

to distinguish in practice; that it, in any event, primarily injures only higher cost competitors; that its presence may well be "wrongly" asserted in a host of cases involving legitimate competition; and that to allow its assertion threatens to "chill" highly desirable procompetitive price cutting. For these reasons, we believe that a precedent allowing this type of attack on prices [...] would more likely interfere with the procompetitive aims of the antitrust laws than further them' (para. 30).

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hand in hand with the potential exclusionary effect of a given practice, all else equal.[12]

### Different policy rules according to different conditions across jurisdictions

As just set out, striking the right balance between over-enforcement (protecting inefficient competitors) and under-enforcement (letting a dominant firm take unfair advantage of its market position, causing in turn consumer harm) is not straightforward. Throughout the book, we suggest some policy rules which recognise and seek to resolve this trade-off in a reasonably effective way.

We need to acknowledge, however, that there may be economic, historical, institutional and legal considerations which may affect the optimal policy rules, particularly in the area of exclusionary practices. For example, the fact that the US approach has been typically less interventionist than the one in the EU may well reflect different economic contexts. In the US, where markets have generally been open and entry has tended to be relatively easy (because of potentially lower administrative barriers and because in a larger fully integrated market fixed entry costs may be recovered more easily), it may be safer to rely on market forces to solve exclusionary issues. Less so in Europe, which has traditionally known persistent positions of market power and less dynamic markets, or in less developed countries. Tapia and Roberts (2015), for instance, state that in developing countries 'entrenched interests [...] have cornered certain markets and the rents that can be earned'. They associate this with various factors, such as large economies of scale (relative to the size of the local markets), obstacles to transport, the influence of well-connected business groups and families and the legacy of state support. For all these reasons, it is less likely that such countries may rely upon market forces to the same extent as in the US.

As a consequence, certain policy rules which may be relatively uncontroversial in the US may perhaps not fit less developed economies equally well. In the context of this book, in Chapter 5, for instance, we suggest

[12] A peculiarity of the approach to the enforcement of Article 102 is that the European Commission and the Courts seem ready to accept that certain practices (for example, exclusive dealing) may be legitimate when adopted by a firm which is not dominant; but as soon as the dominance threshold is met, the same practice may be presumed anti-competitive, potentially even at low levels of dominance. From an economic perspective, dominance (that is, market power) does matter, but it is a question of *degree* rather than a *binary* concept.

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several limiting principles for intervention in refusal to deal cases, such as indispensability of the input and scarce investment on the part of the owner of the input. This is because in striking the balance between, on the one hand, protection and incentivisation of investments and, on the other hand, promotion of competition, it is the former which should typically be privileged. But in a less developed economy, where entry is difficult and rare, and if the input is owned by an entrenched 'super-dominant' firm which has historically enjoyed a privileged position, a more interventionist approach by competition authorities might be justified.[13]

### Effects-based *versus* form-based approach

In the mid-2000s, the two US competition authorities (Department of Justice and Federal Trade Commission) made an effort to draw guidelines on how to enforce Section 2 of the Sherman Act.[14] Building on a number of hearings of academics and practitioners, the ensuing Section 2 report and recommendations were adopted by the Department of Justice in 2008, while a majority of the Federal Trade Commission's panel of commissioners opposed them, mainly on the ground that they would have led to too weak enforcement of anti-competitive conduct by single firms. This report was eventually withdrawn in May 2009.[15] More recently, courts and commentators alike have hotly debated how to deal with pricing conduct and the circumstances under which above-cost pricing should constitute a safe harbour (see our discussion of *Meritor* and *Eisai* in Chapter 2).

In the EU, most of the discussion on how to enforce abuse of dominance provisions has revolved around whether or not to adopt an *effects-based* approach rather than a *form-based* approach. The former assesses practices by the effects they have on consumer welfare, independently of the form

[13] In the same vein, Motta and de Streel (2007) argue that excessive pricing actions in antitrust may be justified in situations where (i) there are high and non-transitory barriers to entry and a very strong dominant position unlikely to be challenged, and (ii) the super-dominant position is the result of exclusive or special rights and legal concessions. Both conditions are less likely to be satisfied in the US than in both Europe and (especially) some developing countries.

[14] See http://govinfo.library.unt.edu/amc/, setting out the role, activities and outputs of the (now defunct) Antitrust Modernization Commission.

[15] For further background, we direct the reader to a speech by the then Federal Trade Commissioner J. Thomas Rosch ('Thoughts on the Withdrawal of the DOJ Section 2 Report', delivered to the IBA/ABA Conference on Antitrust in a Global Economy on 25 June 2009); and to a speech by the then Assistant Attorney General within the Antitrust Division at the Department of Justice Christine A. Varney ('Vigorous Antitrust Enforcement In This Challenging Era', delivered to the United States Chamber of Commerce on 12 May 2009).

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they take. Consider, for instance, an agreement between a buyer and a supplier which commits the buyer not to purchase from rival suppliers (we refer to this as exclusive dealing throughout the book). Under a form-based approach, exclusive dealing by a dominant firm would be typically found anti-competitive by its very nature, independently of the market circumstances and of their effects. However, exclusive dealing may also protect investments by the supplier, and economic principles would call for an assessment of the ultimate effects on consumers, that is, whether pro-competitive effects balance (or even outweigh) anti-competitive ones or not. Accordingly, an effects-based approach would treat different practices having the same effects in the same way. By contrast, a form-based approach may end up treating them differently precisely because the practices take a different form, and hence fall into different categories. But this may have the perverse consequence of promoting 'abuse-shopping' by dominant firms, namely looking for the practice which – while achieving the same exclusionary objective – has the highest probability of staying below the radar of a competition authority or court and thus remain unchallenged.

In the mid-2000s, the European Commission started to reconsider the form-based approach followed (and fully endorsed by the courts) until then.[16] This resulted in the publication of a Discussion Paper on the application of Article 102 to exclusionary practices,[17] and in the Commission issuing a Guidance Paper on the enforcement priorities[18] which were fully aligned with economic thinking and announcing an effects-based approach in the Commission's forthcoming enforcement in this area.

As we discuss in Chapter 2, it is not clear to what extent the Commission has followed in practice such effects-based principles. More importantly, several court judgments appear not to have moved from a form-based approach. This perhaps has culminated with the *Intel* judgment of the

16 A role was perhaps played by the *Michelin II* case, that many perceived as having gone too far in this formalistic approach to Article 102. Prior to that judgment, standardised volume discounts – unlike most rebate schemes – had been deemed legal, but the General Court considered that they were anti-competitive as well, despite possible efficiency justifications and despite the existence of strong competitors (whose market share was increasing even during the period of the alleged infringement) – see Motta (2009) for an account of this case. It may also matter that the European Commission had already embraced an economic approach when dealing with mergers, so that an alignment of enforcement may have appeared necessary.

17 Directorate-General for Competition (European Commission) (2005).

18 European Commission (2009).

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