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## Reform of Article 82

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### Introduction

When I first started to practise, competition law was a niche activity. Few had heard of it and fewer still knew anything about it. Today, all around the world, policy makers recognize that a system of competition law is essential to the successful operation of a market economy and the protection of consumers. And an essential element within the competition tool box is enforcement. It is important that competition authorities intervene to prohibit, punish and deter behaviour that is harmful to consumers. But to serve its purpose, intervention must be based on sound economic principles - it would be contrary to the aims of competition policy if the effect of intervention were to discourage or inhibit efficient behaviour. That would harm consumers rather than benefit them.

In recent years, the focus of EC competition policy has shifted from legal form to economic effect. The 1999 block exemption regulation for vertical agreements is a prime example: it reflected economic reality by creating a larger safe harbour for vertical agreements in unconcentrated markets. Similarly we have seen a greater focus on cartels: large fines and whistle-blowing, encouraged by leniency regimes drawing their inspiration from game theory, have featured in a number

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<sup>1</sup>This paper was prepared as a personal contribution to the debate on the Commission's Discussion Paper on the application of Article 82 to exclusionary abuses. It should not necessarily be taken as reflecting an official OFT view or position.

of major cases – including vitamins, lysine, citric acid, graphite electrodes, and plasterboard. Cartel activity has become much more risky and far less attractive.

More recently, on 1 May 2004, the system of notification for agreements came to an end as part of the 'modernisation' of EC competition law. This also allowed competition policy on agreements between companies to become more economics-based in terms of enforcement priorities, processes and substantive analysis. This is reflected in the Commission's Notice on Article 81(3), where consumer welfare and allocative efficiency are stated to be the objective of Article 81.

1 May 2004 also saw the entry into force of the revised EC Merger Regulation. Among other things, this changed the test for merger appraisal from whether the merger would create or strengthen a dominant position to whether the merger would significantly impede effective competition. The new test is more attuned to the economic purpose of merger policy and is close to, if not the same as, the 'substantial lessening of competition' test in the law of the US and a number of other countries including, since June 2003, the UK. The new EC Merger Regulation was accompanied by economics-based horizontal merger guidelines. Economics now plays a stronger role in merger appraisal within DG Comp than previously – the creation of the position of chief economist is one indication of this. And recent judgments of the Community Courts also suggest that Luxembourg will require more economic rigour in merger analysis.

The one anomaly in all of this has been Article 82: the recent judgments of the CFI in *British Airways* and *Michelin II* have, in my view, their roots in the ordoliberal, form-based traditions that dogged Article 81 for decades.

The DG Comp Discussion Paper breaks away from these traditions by proposing to bring Article 82 within the consumer harm framework.

To quote from the Discussion Paper:

'With regard to exclusionary abuses the objective of Article 82 is the protection of competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources ... it is competition, and not competitors as such, that is to be protected ...'

The Commissioner herself made the position clear in a speech given shortly before the publication of the Discussion Paper:

'Article 82 enforcement should focus on real competition problems: in other words, behaviour that has actual or likely restrictive effects on the

market, which harm consumers ... it is competition, and not competitors, that is to be protected ... ultimately the aim is to avoid consumer harm. I like aggressive competition – including by dominant companies – and I don't care if it may hurt competitors – as long as it ultimately benefits consumers. That is because the main and ultimate objective of Article 82 is to protect consumers, and this does, of course, require the protection of an undistorted competitive process on the market'.

This shift to a focus on consumer harm is something I very much welcome, both for conceptual and for practical reasons. The shift aligns analysis under Article 82 more closely with modern economic thinking, but it also promotes consistency and coherence of EC competition law following the reforms of Article 81 and the EC Merger Regulation.

However, the premise of the Discussion Paper is that an abuse consists in conduct which gives rise to a 'market distorting foreclosure effect' (for which there is no objective justification and which does not give rise to efficiencies outweighing that effect). In order to determine whether there is likely to be a 'market distorting foreclosure effect' the Discussion Paper relies heavily on the 'as efficient competitor' test. In simple terms, if an 'as efficient competitor' is likely to be excluded, Article 82 will bite. The Discussion Paper proposes a number of cost-based 'rules' to determine this. If the behaviour under review falls foul of the relevant cost-based 'rule', the Commission will assume that there is a 'market distorting foreclosure effect' if it affects a sufficiently large part of the market.

I would like to make three points on this.

First, a key issue that has to be considered is whether the assessment of an exclusionary abuse should stop at this stage. Or should we go further and look at whether it is likely that consumer welfare would or could be affected? Since the mere exclusion of an 'as efficient competitor' may not have a negative effect on price and output, it may be appropriate to require competition authorities to put forward a plausible theory as to why the elimination of an 'as efficient competitor' in the particular market in question would or could result in consumer harm.

Just to be clear, I am not suggesting here that cost tests cannot be applied in a way that is consistent with the focus of Article 82 on consumer welfare. They certainly can. But there is a risk that the tests outlined in the Discussion Paper will lead to a formalistic approach which does not necessarily reflect consumer harm in the particular market context. I would welcome further debate on this important issue.

Second, cost-based tests are not the panacea that some assume. Assessing the effect of low prices is very difficult. Inflexible rules may not always work and even prices below average variable cost may be harmless and, indeed, beneficial to consumers. A prohibition of behaviour based on a mere cost/price comparison may deter pro-competitive behaviour to the detriment of consumers. This is well illustrated by one of our cases involving an allegation of predatory pricing in the Edinburgh bus industry. The OFT examined the pricing of the allegedly dominant company, First Edinburgh, and found that it was likely to have been below average variable cost for many months and on a significant number of routes. Whereas this gave rise to a strong presumption of predation, the OFT's analysis did not stop there. The OFT went on to examine the evidence 'in the round', taking account in particular of whether the conduct had 'the effect of weakening or distorting competition in the relevant market'. The OFT examined internal planning and strategy documents prepared at the time of the alleged abuse and concluded that First Edinburgh's activities were not intended to force its competitor, Lothian, out of the market. Rather, the evidence indicated that the strategy was an attempt to improve on poor performance and to establish a more comprehensive network. The OFT also considered the financial situation of Lothian and found that there was no risk that it would be forced out of the market by First Edinburgh's activities. In particular, while Lothian's return on turnover was low and its return on capital employed was declining, it was unlikely that its profitability was below its cost of capital. The outcome of the allegedly predatory pricing was, therefore, that consumers in Edinburgh benefited from a period of low fares and higher frequencies without competition being weakened. Intervention by the OFT would, on the other hand, have led to higher prices, lower frequencies and consumer harm.

Third, as the Discussion Paper itself acknowledges, there are both conceptual and practical barriers to implementing cost-based tests. Allocating costs in an economically meaningful way is often a huge challenge. The most obvious example is the task of allocating common costs – such as shared manufacturing, distribution and marketing costs – to a product under investigation. The method used must take into account the circumstances of the case.

Cost allocation is also often dependent on the time frame in question. The concept of average avoidable costs for example, which is proposed in the Discussion Paper as a benchmark for predation, is preferable to average variable costs but still depends critically on selecting an appropriate period of time.

The treatment of capital investment expenditure can also be controversial. For example, what time frame should be used for capital investment expenditure in margin squeeze cases? Should it be one year or should it be a number of years?

Clearly, the appropriate methodology depends on the circumstances of the case, and to some extent, subjective judgment. Similarly, cost tests such as the margin squeeze test allow the dominant company to make a reasonable return on capital. But establishing the appropriate rate of return is not easy to do – particularly when there is no close or obvious industry comparator upon which to draw.

Finally, effective cost tests are not just about identifying the right costs but also about establishing revenues. For example, revenues often have to be separated out from bundles in a meaningful way. The Discussion Paper proposes a test which compares the incremental price of a bundle to the incremental cost of supplying the additional component in the bundle. Whilst this test is a good starting point, it cannot be the whole story. Incremental pricing is used in the Discussion Paper as a substitute for incremental revenue. However, the two are not synonymous – there are situations in which a company could have incremental prices below incremental costs and still be profit maximizing in the absence of any exclusionary effects. In such cases, intervention would again harm consumer welfare.

Let me now turn to some specific aspects of the Discussion Paper. I would like to deal with the following points: first, whether the consumer harm focus is consistently applied throughout the paper; second, efficiencies and the burden of proof; and third, dominance. I would also like to make a few points about private actions.

#### **Inconsistency of approach: elements of form-based approach remain**

As I have already indicated, the focus of the Discussion Paper on consumer harm is to be welcomed, as is the general analytical framework discussed above. However, the framework is not always applied in a consistent way.

For example, rebates can have the same foreclosure effect as classic predation but involve a much lower sacrifice of profits than classic predation does. For this reason, the Discussion Paper proposes different cost tests for assessing the two forms of conduct. The benchmark adopted in the Discussion Paper for assessing potential predatory pricing is, rightly, average avoidable cost, whereas the benchmark for assessing potentially exclusionary rebates is average total cost.

It does not follow, however, that consumer harm will occur when the average total cost test for rebates is met – to make this connection is to assume consumer harm based largely on the form of the conduct. This is arguably not consistent with the consumer welfare approach or the general analytical framework.

Another example of where some elements of the form-based approach may have survived is in refusal to supply. The Discussion Paper deals with the situation where a company is dominant in an upstream market and is also active in a downstream market. The view taken in the Discussion paper is that if the dominant company terminates supplies of the relevant input to one of its competitors downstream, it will normally be presumed that there is a negative effect on competition in the downstream market. It seems to me that this is similarly not consistent with the consumer welfare approach or the general analytical framework.

Further debate on these points would be welcome.

### **Efficiencies and the burden of proof**

I want to turn now to the question of efficiencies and the burden of proof.

The recognition of efficiencies as a justification for certain forms of conduct is very welcome. However, the treatment of efficiencies in the Discussion Paper raises a number of issues.

First, the degree of enforcement of Article 82 will depend to a large extent on where the burden of proof lies. The Discussion Paper suggests that once a likely market distorting foreclosure effect has been established, the burden shifts to the dominant company to prove that one (or more) of the 'defences' is available. It is possible that, if the dominant company is required to show that the efficiency criteria are fulfilled, a presumption of abuse will be created which is, in practice, irrebuttable. However, under Regulation 1/2003, the burden of proving an infringement rests on the party or authority alleging the infringement. It would not seem possible to circumvent this principle by claiming that the 'defences' under Article 82 should be regarded as analogous to Article 81(3) – where the burden of proving the exemption rests with the company. There is no Article 82(3) in the EC Treaty.

The consequences of shifting the burden of proof may be less of an issue if the dominant company is only required to put forward a *plausible case* that one of the 'defences' described in the Discussion Paper is available. In this situation, the onus would then shift back to the claimant or the authority to show that the defence is not established. In other words, I would draw a distinction between the legal burden of proof and the 'burden of adducing evidence'. This distinction is clear from Advocate General Kokott's Opinion in *FEG v Commission*, where she said that the parties have a burden of adducing evidence in support of their respective assertions 'before there is any need to allocate the burden of proof at

all'. She went on to say that the companies concerned cannot refute the Commission's findings simply by disputing them. They have the burden of adducing arguments and evidence that show 'why the information used by the Commission is inaccurate, why it has no probative value, or why the conclusions drawn by the Commission are unsound'.

Just to be clear, I support DG Comp's innovative thinking in this area but would suggest that the follow-up to the Discussion Paper should clarify that the shifting of the burden of proof relates to the 'burden of adducing evidence' rather than to the legal burden. Should DG Comp, however, wish to shift the legal burden I believe that we will need to consider carefully whether the proposed prescriptive approach to abuse in the Discussion Paper is appropriate in all circumstances. We will also need to reassess our understanding of dominance.

### **Dominance**

This in fact brings me onto the third aspect of the paper I would like to touch upon – dominance.

If we are to see a fundamental change in the way Article 82 is applied, the Commission will, in my view, need to take the lead in this area as well. Although the Community Courts clearly have the power to bring about the necessary changes, they are unlikely to do so, at least until they are faced with a case in which the application of a form-based rule would very obviously be flawed.

The Discussion Paper already sets out new thinking on the concept of abuse, and puts forward innovative proposals. However, as regards dominance, the current paper only summarises the existing case law. There is in my view a strong case for assessing whether a more innovative approach could be taken to dealing with the concept of dominance. The low threshold at which dominance can be found has been a major problem in the application of Article 82 – dominance suffers from the same ordo-liberalist flaws as the concept of abuse does and if discussion and review does not take place now, problems with the practical application of Article 82 are likely to remain. Although I am not arguing that the threshold for dominance should necessarily be raised, I do think that we would benefit from a more thorough debate on what is the appropriate threshold for dominance and what the appropriate analytical framework for its assessment should be.

Even if the current approach is maintained, we will need to consider three issues more carefully.

First, the role of market shares. The Discussion Paper has, albeit implicitly, abandoned the idea that dominance can be presumed through high market shares alone. This is a clearly a very positive development. However, too much emphasis is still placed on shares. For instance, the Discussion Paper states that: 'it is very likely that very high market shares, which have been held for some time, indicate a dominant position. This would be the case where an undertaking holds 50 per cent or more of the market, provided that rivals hold a much smaller share'. Given the vagaries of market definition, such an approach, allied with a presumptive approach to abuse and the shifting of the burden of proof on efficiencies, could have serious consequences in terms of false positive errors, especially by national courts.

The second issue which I would highlight is the Discussion Paper's approach to collective dominance. Clearly, one possible implication of the doctrine of collective dominance is that intervention may occur below (and possibly well below) the levels naturally associated with single firm dominance. The Discussion Paper explicitly states that 'the abuse does not necessarily have to be the action of all the undertakings in question. It only has to be capable of being identified as one of the manifestations of the collective dominant position'. This wording follows paragraph 66 of *Irish Sugar*. However, the case law on this matter is complex and still developing. In my view the risks of unwarranted intervention are high in such cases, particularly in private actions before national courts. Further thought needs to be given to the form of any future guidance on these issues as the stakes in terms of false positive errors and deterrence of efficient behaviour are likely to be high. It might be worth noting that as a matter of prosecutorial discretion, the OFT is very unlikely to take cases falling within this category.

Third, the Discussion Paper suggests a so-called 'sliding scale' approach to the assessment of abuse, which turns on the relationship between the degree of dominance and the likelihood of consumer harm. This is potentially an important development reflecting economic reality. The fact that the degree of market power can be used in the assessment of the likelihood of effects on price and output is already recognized in the Commission's guidelines on Article 81(3). This, however, requires a thorough and proper analysis of market power as opposed to a legalistic assessment of dominance. If the sliding scale approach is to be retained, which I favour, there will need to be a more detailed explanation of how it would work in practice, possibly as part of any reassessment of dominance.

## **Private actions**

I have already noted my nervousness about the way in which the Discussion Paper as currently drafted might be used in national litigation. The Commission recently published a Green Paper on damages actions which has triggered an intense debate. We strongly support the idea that parties harmed by anti-competitive behaviour should be able to seek damages before the national courts. Vigorous private enforcement is, in my view, a necessary component of an effective competition regime. It brings private resources into the enforcement process and increases deterrence.

Increased private enforcement, however, also means that national courts will be applying Article 82 more frequently, adjudicating private disputes and contributing to the development of the law and policy in this area. If this Discussion Paper leads to the publication of Commission Guidelines, or guidance in some other form, on Article 82, national courts are likely to have regard to such a document, not least under the duty of sincere cooperation enshrined in Article 10 of the EC Treaty. In light of this, it is essential that any guidance on Article 82 is framed in such a way as to ensure appropriate intervention by national judges throughout the European Union. Guidance which is too complex, detailed and prescriptive might lead national courts to apply Article 82 in a formulistic way. It would also risk uncertainty and divergent interpretations in the Member States, ultimately resulting either in over-intervention (if welfare-neutral or welfare-enhancing conduct is found to fall within the guidance) or under-intervention (if harmful conduct is found not to be covered by the detailed descriptions in the guidance). Of course, DG Comp's document is a Discussion Paper and it is appropriate for the paper to raise all the issues that need debating. It may be the case, however, that DG Comp ultimately decides to issue guidance which will distil from the debate we are having now clear but flexible principles rather than prescriptive rules.

## **Conclusion**

The law on abuse of market power is far from settled and continues to evolve. The volume of case law under Article 82 compared to that under Article 81 is modest. The Commission seems to have accepted that the existing case law should not hinder the present review. This is something I fully support.

In my view, the Discussion Paper lays down the right foundations for a fruitful debate: the purpose of Article 82 is to enhance consumer welfare and achieve an efficient allocation of resources. However, there are still some important questions that need to be considered. What should we do with dominance and how should it be assessed? How is the consumer harm principle best applied in

the analysis of individual abuses? How far can we be confident that the exclusion of an 'as efficient competitor' is likely to harm consumers, without further investigation? How much of a case should a competition authority and a dominant company be required to show in order to minimize the risk of unwarranted regulatory intervention while making the enforcement of Article 82 practicable and workable?

Papers written on this subject in the last few years have been titled 'Whither Article 82?' and 'Article 82 – Where Next?'. As a result of the Discussion Paper, I think we now broadly know the road on which we have embarked, namely to bring the application of Article 82 into line with the rest of EC competition law in order to ensure consistency and coherence. But I do not doubt that it will be a road with the occasional diversion, z-bend and perhaps even u-turn. I hope that my comments provide a useful starting point to the presentations and discussions today.

At the OFT, we look forward to further debate on these, and many more, questions and to contributing to the ongoing development of law and policy in this area.

Thank you.