



Exploitative Abuses

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1. Introduction

This paper investigates the role of exploitative abuse under Article 82. Unlike exclusionary practices, there is relatively little economic commentary on the proper role of exploitative abuses in competition policy,¹ even though the legal perspective in Europe has consistently emphasized the importance of enforcing antitrust action in the arena of exploitative practices.²

In this paper I will address the following two questions: what are the effects of antitrust action against exploitative conduct? and when to take antitrust action against exploitative abuses?

Before addressing these questions I like to make some general observations about Article 82.

Let me begin by stating that any anticompetitive behavior involves both exclusionary and exploitative abuses. Anticompetitive conduct must ultimately lead to exploitation. In fact, the sole purpose of firms engaged in business through exclusionary practices is to increase once market power, which in turn will allow firms to increase their rents. The typical anticompetitive story is thus one in which a firm reduces competition through anticompetitive means (exclusion) in order to reap the benefits of higher market power (exploitation). In this sense, exclusionary and exploitative abuses are part of the same economic logic for antitrust, and it is no surprise that both types of behaviors are at the core of Article 82.

Against the backdrop of this basic economic logic on how markets work, it is important to understand that while it is correct to say that "*one excludes in order to exploit*", it is not correct to say that all exploitation is rooted in

¹ See for example Evans, D. S., and A.J. Padilla. (2005). Excessive Prices: Using Economics to Define Administrable Legal Rules. *Journal of Competition Law and Economics*, or Motta, M., and A. de Strel (2006). Excessive Pricing and Price Squeeze under EU Law. In *What is an abuse of a dominant position?* ed. Claus-Dieter Ehlermann and Isabela Atanasiu, 91-126. Oxford: Hart Publishing.

² See the paper by E. Paulis in this volume entitled "Article 82 and exploitative conduct" for a historical account of the balance between exclusionary and exploitative abuses under Article 82.

exclusionary abuse. In fact, the essence of pro-competitive behavior is to increase market power, which will in turn increase rents by means of exploiting this very market power. In fact, if there was no possibility to ever exploit ones market power, there would be no incentive to compete.³ Thus, pro-competitive behavior must also involve exploitation (“positive effects”).

Another possibility is that government has - or has in the past - granted an exclusive right, such as in network industries like post, telecommunication, rail, etc. As a result, firms may hold strong market positions and price accordingly, if left unregulated. In this situation, exploitative abuses would not be due to exclusionary conduct.

The above suggests that both pro and anti-competitive behavior involve exploitation. Since the goal of antitrust is to discriminate between pro- and anti-competitive conduct, it follows that the mere existence of exploitative behavior is not sufficient for identifying anti-competitive practices. By contrast, the existence of exclusionary practices does provide a sound basis for identification anti-competitive behavior. As a result, one might conclude that it is indeed solely exclusionary conduct that antitrust should focus on.

In this spirit, I now turn to the first question asking what the economic basis for antitrust action under exploitative conduct might be (Section2) before coming back to the above point on the proper role of exploitative abuse in Europe (Section 3).

³ This includes situations were firms are under bankruptcy threat. In this case, engaging in pro-competitive behavior allows forms to increase their rents, even though they are close to zero (as opposed to negative).

2.

What are the effects of antitrust action against exploitative conduct?

Perhaps the most widely held view in favor of antitrust action on the grounds of excessive pricing is that it leads to lower prices and thereby increases consumer surplus.⁴ It is argued that the price reductions benefit consumers in a direct and short run way. Given that consumers are at the heart of competition policy, excessive pricing interventions are therefore an integral element of antitrust enforcement.

Despite a certain appeal of the above argumentation, there are very credible arguments as to why excessive pricing interventions in fact will not benefit consumers. Whether prices are higher or lower under antitrust enforcement is fundamentally associated with the analysis of the relevant counterfactual. In other words, one has to address what the prices would have been (both in the short and long run, i.e. is the price reduction temporary or not?) in the absence of antitrust actions (or the threat of it). In other words, one has to take the likelihood of entry into account and how antitrust intervention affects this.

Whether entry takes place or not depends on the existence and magnitude of entry barriers. There are a number of different types of entry barriers, such as strategic entry barriers (i.e. excess capacity and first mover advantages), legal entry barriers (i.e. access regulation, IPR), absolute cost advantages, asymmetric information, etc. If such entry barriers are not significant, high post entry margins attract entry. In other words, the market does self-correct. Since excessive pricing antitrust enforcement lowers post-entry margins, it will tend to discourage entry and negatively affect the market's propensity to self-correct, which may lead to higher prices. For this reason, it makes sense to restrict

⁴ This section will couch the discussion on exploitative abuses in terms of excessive pricing, which constitutes the vast majority of all antitrust cases.

antitrust interventions in the arena of excessive pricing to situations where entry barriers are so high that entry (absent antitrust action) is unlikely.⁵

A further fundamental objection against the use of excessive pricing interventions is that it negatively affects investments and/or innovation. By lowering prices *ex post*, incentives to invest or to innovate *ex ante* are reduced or even eliminated. As was mentioned above, the essence of pro-competitive behavior is to increase market power, which will in turn increase the incentive to invest or innovate. In industries where innovation or large up-front investments play a major role, consumers ultimately do not benefit from excessive pricing interventions.

A final reason why excessive pricing intervention may not benefit consumer is that it is very difficult to assess. What constitutes an “excessive” price is a difficult question to answer, without relating to practically all aspects of a market and its competitive environment. Invariably, price-cost tests are bound to raise a number of difficult methodological questions, such as cost allocation, efficient costs, what is the proper benchmark, and what is the nature of competition (including demand).

An example of these difficulties of empirically assessing price-cost margins can be illustrated by a recent analysis of past data from the European airline industry.⁶ In a structural approach, all the above aspects of competition are taken into account (demand, cost, as well as the competitive nature of the industry) in order to properly estimate price-cost margins. In addition, the authors allow for “endogenous costs”, i.e. costs are linked to product market competition through unions in the following way. If price-cost margins are high, unions bargain for higher wages, which in turn raises costs thereby lowering price-cost margins. If, on the other hand, price-cost margins are low, union demands are moderate, which will excerpt upward pressure in price-cost margins. In equilibrium, all these factors are taken into account and balanced. The main result of the study is as follows. Observed prices in the European Airline industry are virtually identical to monopoly prices, even though observed margins are consistent with competition. The reason is that costs had been inflated to the point that the European consumers were faced with *de facto* monopoly prices. In other words, the empirical evidence suggests that prices have been “excessive”, while price-cost margins are “normal”.

In sum, antitrust action under the banner of exploitative abuses needs to be applied with great caution. Not only is it difficult to identify price-cost margins

⁵ Another important issue is to what extent prices in related markets are affected by the intervention. For example, some commentators claim in the recent debate on the regulating international roaming shows that the impact of price regulating roaming charges will lead to higher prices in domestic markets. I am not aware of much analytical results in this area of antitrust economics, let alone systematic empirical evidence. Absent formal analysis, a reasonable conjecture is to assume that firms will raise prices in related markets, whenever antitrust action lowers prices in complementary markets, while the opposite happens when products are substitutes.

⁶ Neven, D. J., Röller, L.-H., and Z. Zhang. (2006). Endogenous Costs and Price-Cost Margins. *Journal of Industrial Economics* 54 (September): 351-368. The data analyzed in this paper covers the period from 1976-1994. This period is particularly well suited to analyze the impact of unions. Notice also that low-cost airlines did not play a major role at that time.

properly, but also is it far from obvious what an “excessive price” would be and how antitrust action would then benefit consumers.

3.

When to take antitrust action against exploitative abuses?

Let me now return to the statement made in the introduction, namely since pro and anti-competitive behavior both involve exploitation, it is indeed solely exclusionary conduct that antitrust should focus on. If anything the discussion summarized in the previous section would certainly support such a policy. However, I do believe that antitrust action against exploitative abuse does have a role to play, even though only under certain circumstances.

i. "Gap cases"

In principle, an abuse case must identify anticompetitive conduct that results in increased market power, relative to the counterfactual. As was mentioned above, it is the road to dominance that is important in order to identify pro- from anticompetitive conduct. If dominance (or for that matter any kind of market power) is obtained through competition on the merits, then this is good for consumers; otherwise, not. By contrast, Article 82 only applies to firms that are *already* dominant. In other words, anticompetitive conduct that *leads* to a dominant position can not be caught in Europe under exclusionary abuse. This is an enforcement "gap", since it is precisely the way in which dominance is acquired that matters in terms of economic effects.⁷

I like to suggest that antitrust enforcement through exploitative abuse can be used to close this important gap. That is, exploitative abuse cases should be based on acquiring a dominant position through anti-competitive exclusionary

⁷ There may be other gaps under Article 82, such as anticompetitive conduct below the level of dominance, or anticompetitive behavior by an oligopoly.

conduct. In this way, exploitative abuse cases are back to investigating exclusionary conduct, which is in fact the proper way to identify anticompetitive conduct. By focusing on the road to dominance through anticompetitive behavior, exploitative abuse cases are firmly grounded in the way markets work, rather than deciding on what is “excessive” from an ex post point of view.

Note that this approach is very much in line with the observation that many exploitative cases exist in sectors with former state owned monopolies. Perhaps this observation has something to do with the fact that these firms did not get their dominant positions based on merit alone, but rather by a public policy decision usually based on a natural monopoly policy. To the extent that the road to dominance matters, these should in fact be considered gap cases, even though dominance is not achieved by anticompetitive exclusionary conduct.

Overall, there appear to be three main advantages in defining exploitative abuse as acquiring dominance as a result of an exclusionary abuse: First, it is in line with sound economics, second it avoids the standard debate on what is “excessive” (which, I believe, is impossible to define operationally), and third it closes a gap in Article 82.

ii. “Mistakes”

A second reason for antitrust action against exploitative abuses may be “mistakes”, i.e. for some reason an antitrust authority has not effectively prosecuted an exclusionary abuse. In this situation, one may argue that since the exclusionary abuse was not caught or perhaps because it was uncertain as to the effect of the exclusionary conduct (type II error), a second enforcement shot through the application of exploitative abuses is needed (a “two shot” policy).

A related argument is that the mistakes are due to *uncertainty*. Given that exclusionary abuses are based on “likely effects”, there is of course then also a likelihood that the agency gets it wrong. As a result, one may argue that two instruments are better than one. In other words, exploitative abuses can be stopped, whenever the exclusionary abuse has had an actual effect, which was deemed unlikely at the time.

On the other hand, one may legitimately wonder whether the better policy response is not to eliminate the mistakes (or reduce the uncertainty), rather than having a two shot policy. For example, it maybe too late once an exclusionary abuse has taken place. Moreover, a two shot policy may give rise to over-enforcement, leading to more type I errors, while reducing type II errors.⁸

iii. When to take action

Summarizing the above argumentation one may conclude that exploitative action under Article 82 are limited to very special circumstances. Building on the above

⁸ Note that mistakes may go either way, i.e. there are type I and II errors under exclusionary abuse cases. A two shot policy based on uncertainty about the likely effects would check the actual effects ex post. In principle, there will be cases where both type I and II errors can be found. Nevertheless, one would presume that a two shot policy would only be applied when type II errors have occurred (i.e. an exclusionary abuse was not caught).

discussion, the following circumstances for antitrust action through excessive pricing abuse can be identified⁹.

- a) significant entry barriers
- b) market unlikely to self-correct
- c) no (structural) remedy available [=> otherwise advocacy]
- d) no regulator or regulatory failure [=> otherwise *ex ante* regulation]
- e) "gap case" or "mistake cases" [=> otherwise exclusionary abuse]

The above conditions are cumulative, i.e. they are necessary conditions and must all be met. The first two conditions (a) and (b) have already been discussed and are self-evident. If no entry barriers exist or if the market would self-correct there is no compelling need to intervene. The market is best left to itself and consumers will benefit.

Condition (c) and (d) have not been addressed above, but have been mentioned by other authors. They are based on the fact that exploitative abuse cases (especially excessive pricing) are essentially price regulation and that there are better placed instruments and institutions to deal with this. Specifically (c) specifies that if there are structural remedies available - such as removing relevant entry barriers, open markets, liberalize, etc. - then the proper policy would be advocacy in favor of these structural remedies, and not exploitative abuse cases. To the extent that exploitative abuse cases can be used to achieve structural remedies, or that exploitative abuse cases are complementary to advocacy action, then exploitative abuse cases under Article 82 would be helpful, but only because they support a structural remedy.

Similarly condition (d) specifies that regulatory type antitrust action (as in excessive pricing cases) is only warranted if there is no regulatory agency, or if the regulator does not operate effectively. Where there is a regulator, intervention by an antitrust authority is thus limited, as specialized regulatory institutions are likely to have superior regulatory know-how. However, antitrust intervention remains possible, not least because industry-specific regulators are more likely to be subject to regulatory capture (and hence may fail to protect consumer welfare) than an antitrust authority, whose competence extends horizontally across most or all economic sectors.

Finally, condition (e) refers to the "gap case". As argued above it relates to cases where dominance is a result of exclusionary conduct, not the other way around. If this condition is not met, then any relevant anticompetitive conduct can be addressed through exclusionary abuse, in other words, exploitative cases are unlikely to discriminate between pro- and anticompetitive conduct, run into methodological problems, and are difficult to implement in line with sound economics. Recall that there is also the possibility of achieving dominance through government action, which are also gap cases.

⁹ Again, I concentrate on excessive pricing, as this is the most prominent area.

Condition (e) also mentions "mistake cases", primarily for completeness. However, the above discussion has expressed some doubt as to the appropriateness of arguing that a second shot is needed.

4. Concluding remarks

I have argued that excessive pricing cases should be limited to certain special circumstances. Focus should be on “gap cases” where anticompetitive exploitation exists if and only if exclusionary abuse - or government actions - has led to a dominant position. Specifically, the road to dominance becomes important in those cases.

Overall, there appear to be three main advantages in defining exploitative abuse, in particular excessive pricing, as acquiring dominance through exclusionary abuse or governmental action: First, it is in line with sound economics (i.e. it better discriminates between pro- and anticompetitive conduct), second it avoids the standard debate on what is “excessive” (which, I believe, is impossible to define operationally¹⁰), and third it closes a gap in Article 82.

Finally, let me submit that the above approach, which directs exploitative abuse cases towards analyzing exclusionary behavior, is in line with an effect-based approach under Article 82.

¹⁰ How do we identify excessive pricing? What is the standard? Recall that any standard based on costs is methodologically doubtful. Note that the approach proposed in this paper does provide a benchmark, which is rather natural and consistent with the rest of Article 82. The benchmark for excessive prices is simply the prices “but for the exclusionary conduct”.

The author

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About ESMT

ESMT European School of Management and Technology was founded in October 2002 on the initiative of 25 leading German companies and institutions. The founders aimed to establish an international business school, based in Germany, with a distinct European focus.

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