

**NELCO**  
**NELCO Legal Scholarship Repository**

---

New York University Law and Economics Working  
Papers

New York University School of Law

---

7-10-2007

# Below-Cost Price Alignment: Meeting or Beating Competition?

Michal Gal

*University of Haifa*, [mgalresearch@gmail.com](mailto:mgalresearch@gmail.com)

Follow this and additional works at: [http://lsr.nellco.org/nyu\\_lewp](http://lsr.nellco.org/nyu_lewp)

 Part of the [Antitrust and Trade Regulation Commons](#), and the [Law and Economics Commons](#)

---

## Recommended Citation

Gal, Michal, "Below-Cost Price Alignment: Meeting or Beating Competition?" (2007). *New York University Law and Economics Working Papers*. Paper 95.

[http://lsr.nellco.org/nyu\\_lewp/95](http://lsr.nellco.org/nyu_lewp/95)

This Article is brought to you for free and open access by the New York University School of Law at NELCO Legal Scholarship Repository. It has been accepted for inclusion in New York University Law and Economics Working Papers by an authorized administrator of NELCO Legal Scholarship Repository. For more information, please contact [tracy.thompson@nellco.org](mailto:tracy.thompson@nellco.org).

# Below-Cost Price Alignment: Meeting or Beating Competition?

Michal S. Gal\*

A slightly different version is forthcoming  
28(6) *European Competition Law Review (ECLR)* (2007).

## Abstract

May a dominant firm justify below-cost pricing by simply arguing that it aligned its prices with those of its rivals? In this essay I show that generally the answer is negative. I also argue, however, that such a rule should not be categorical and that in some circumstances a below-price meeting competition defense should be allowed, in order to protect competition. Such an exception is necessary in order to take account of the special economic characteristics of dynamic industries which differ from the brick-and-mortar industry model that assumes that scale economies are small and entry barriers are low. The article exemplifies these arguments by using the EU recent France Telecom case.

## Table of Content

- I. Introduction
- II. France Telecom: Predation allegations
- III. Predation as abusive conduct
- IV: Rule: Meeting competition rejected as an absolute defense
- V. Exceptions: When Meeting competition should allow below-cost prices
- VI. Conclusion

\* LL.B., LL.M., S.J.D. Senior Lecturer and Director of Law and MBA Program, Haifa University School of Law; Academic Fellow, NYU Center for Law and Business. I would like to thank Adi Ayal, Margaret Bloom, Ariel Ezrachi, Val Korah, Amir Israeli, Xavier Lewis and Avishalom Tor for their most thoughtful and helpful comments on earlier drafts. Many thanks to Alex Nathanson for his research assistance. All errors and omissions remain, of course, the author's. For comments: mgalresearch@gmail.com

## I. Introduction

The right of a dominant firm to protect its commercial interests when those have been threatened has long been recognized. The dominant firm is "allowed to take such reasonable steps as it deems appropriate to protect its commercial interest."<sup>1</sup> Otherwise, its hands would be tied behind its back, limiting its ability to compete, thereby harming the very process that the Treaty is meant to protect. At the same time, however, the dominant firm is not given a *carte blanche* in all its activities. Rather, it is prohibited from engaging in abusive conduct by which it uses its existing market power in order to gain an unfair competitive advantage over its rivals by erecting artificial barriers to competition. The intersection of these two principles raises important issues regarding the legality of the methods available to the dominant firm to protect its commercial interests: differentiating legally meeting competition from illegally beating competition.

---

<sup>1</sup> Case T-228/97 *Irish Sugar plc v. Commission* [1999] ECR II-2969, para. 112 and 189. See also Case 27/76 UBC *United Brands Company v. Commission* [1978] ECR 207, para. 189; Case T-65/89 *BPB Industries and British Gypsum v Commission* [1993] ECR II-389, para. 117.

In this essay I explore some aspects of the recent decision of the EU Court of First Instance in *France Télécom SA v. Commission*,<sup>2</sup> which involved allegations of predatory pricing. In particular, I focus on the important building block that the decision adds to the case law by determining that a dominant firm may not justify below-cost pricing by simply arguing that it aligned its prices with those of its rivals. The article argues that this rule fits well with existing case law as well as with the recent calls to adopt a more economic-oriented approach to Article 82.<sup>3</sup> Yet it suggests that the rule adopted by the Court should be further refined in certain circumstances to incorporate the recent economic learning with regard to dynamic industries, if competition were to be protected.

## II. France Telecom: Predation allegations

In *France Télécom* the CFI sustained the Commission's decision<sup>4</sup> that Wanadoo Interactive, a subsidiary of France Télécom which later merged with it, abused its dominant position in the French residential broadband market. It did so, inter alia, by charging below-cost prices for ADSL high-speed Internet services. The Court thereby confirmed the €10.35 million fine imposed by the Commission.

The Court found that Wanadoo was dominant in the relevant market. The finding of dominance was based on Wanadoo's links with France Telecom which granted it technical advantages and the fact that Wanadoo's market shares ranged between 50 to 72% and it always had more than eight times the number of ADSL subscribers than its number one competitor.<sup>5</sup> The CFI also found that Wanadoo priced its products below average variable cost (AVC) for some period and below average total cost (ATC) for another, at a time most critical for the expansion of the relevant market. It was also found that Wanadoo had a plan of predation and intended to preempt the market by such pricing policies. The Court concluded that predatory pricing that does not allow either variable or full costs to be recovered as part of a plan to pre-empt the market, constitutes an abuse of a dominant position.

In finding an abuse in such circumstances, the court followed the line of cases that initiated in *AKZO*,<sup>6</sup> which established that a finding of abuse can be based upon one of two conditions: (1) prices are below average variable cost; or (2) prices are below average total costs but above average variable costs and an intention to eliminate competitors is proven. To the extent that such a rule should be read as a simple and absolute price-cost comparison, it is too rigid because it fails to recognize that prices below AVC may still sometimes be pro-competitive.<sup>7</sup> Yet the dominant firm might still defend its actions by proving a valid objective justification. The ability to rebut

---

<sup>2</sup> Case T-340/03 *France Télécom SA v. Commission*, Court of First Instance (30 January 2007, not yet published).

<sup>3</sup> See, e.g., European Commission, "DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary abuses" (Brussels, December 2005); John Vickers, "Abuse of Market Power" (2005) 115 *Economic Journal* 244.

<sup>4</sup> COMP/38.233 *Wanadoo Interactive*, Commission Decision (July 16, 2003, not yet published).

<sup>5</sup> Wanadoo's shares fell to 64% at the end of the predation period. *France Telecom*, above, para.103. This fact might question the feasibility of the predatory pricing theory, although further analysis is necessary in order to determine its implications.

<sup>6</sup> Case C-62/86 *AKZO Chemie BV v. Commission* [1991] ECR I-3359.

<sup>7</sup> See, e.g. Bellamy & Child, *EU Law of Competition* (Sweet and Maxwell, 2001, 5<sup>th</sup> ed., Peter Roth ed.), p. 725.

the presumption of predation thus largely determines the efficiency of the predatory pricing prohibition, as elaborated below.

Although the Commission's decision also contended with the issue of recoupment, the CFI followed previous case law and did not require such proof as a condition for finding an abuse.<sup>8</sup> This is a missed opportunity. As many commentators have already argued, the possibility of recoupment should be part of the offense or at least provide a valid defense.<sup>9</sup> This is because the rationality of the predatory scheme hinges on the possibility of recoupment: that the predator's long run profitability from the scheme justifies the short-term losses in the first period. If recoupment is not deemed probable at the time the alleged predatory conduct was engaged in, then it must be assumed that the conduct was not predatory, otherwise the firm would not have engaged in it. Moreover, since the costs of a dominant firm usually cannot be measured with much accuracy, the recoupment requirement also serves as a surrogate for such an analysis, to further ensure that the predatory pricing allegations are a rational explanation of the dominant firm's conduct. As the U.S. Supreme Court recently stated in its *Weyerhaeuser* decision, recoupment should be a necessary element in the predatory pricing offense because "[t]he costs of erroneous findings of predatory-pricing liability are quite high because the mechanism by which a firm engages in predatory pricing--lowering prices--is the same mechanism by which a firm stimulates competition, and therefore mistaken liability findings would chill the very conduct the antitrust laws are designed to protect."<sup>10</sup> In addition, if the predatory strategy was not rational since recoupment is not possible since the dominant firm would not be able to raise prices in the second stage, then the dominant firm's conduct actually benefits consumers, as they enjoy the low prices in the first period while not suffering from high ones in the second one. Such conduct should therefore not be prohibited. The recoupment requirement should thus form an inherent part of any assessment of alleged predatory pricing.

The decision adds, nonetheless, to the existing case law in several respects. First, it rejects France Telecom's argument that the fast growing nature of the high-speed internet services market does not warrant the regular application of competition prohibitions. In so doing, the Court emphasized, once again, that the scope of the competition provisions is wide enough to apply to "new economy" industries, so long as proper adjustments are made to take into account such industries' unique features. I shall return to this point in the last section.

Second, and more importantly, the Court rejected France Telecom's defense that it simply aligned its prices with those of its competitors and that "the fact that the prices charged by competitors correspond to prices which are below cost for the undertaking

---

<sup>8</sup> Case C-333/94 P *Tetra Pak International SA v. Commission* [1996] ECR I-595I, para. 44. Some commentators suggest that the court's decision is limited to the facts of the case, in which the dominant firm had a quasi-monopoly and predator was on a market distinct from the preyed one. Alison Jones and Brenda Sufirin, *EC Competition Law* (Oxford, 2001), p. 342.

<sup>9</sup> See, e.g., Emmanuel P. Mastromanolis, "Predatory Pricing Strategies in the European Union: a Case for Legal Reform" (1998) 19 *E.C.L.R.* 211; Niels Gunnar, "Article 82: Effect not Form?" (2006) 5 *Competition Law Insights* 6.

<sup>10</sup> *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.*, 127 S.Ct. 1069, 1077 (Decided Feb. 20, 2007) citing to *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 at 226, 113 S.Ct. 2578.

concerned is of no relevance in this respect."<sup>11</sup> This is the first instance in which such a defense has been squarely dealt with by the courts.<sup>12</sup> The CFI stated that it is "not possible to assert that the right of a dominant undertaking to align its prices on those of its competitors is absolute."<sup>13</sup> Even though a dominant firm can take reasonable steps to protect its commercial interest when those come under attack, "such behaviour cannot be countenanced if its actual purpose is to strengthen [its] dominant position and abuse it."<sup>14</sup> Accordingly, even if the "alignment of prices by a dominant undertaking on those of its competitors is not in itself abusive or objectionable, it might become so where it is aimed not only at protecting its interests but also at strengthening and abusing its dominant position."<sup>15</sup>

On its face, the decision of the Court is much more nuanced than that of the Commission, which took the categorical view that, although an undertaking is not prohibited from aligning its prices with those of its competitors, that possibility is not open to it if it involves charging below-cost prices.<sup>16</sup> The Court's decision differentiates between instances in which a dominant firm meets competition merely to "protect its interests" and those in which it "strengthens and abuses its dominant position." In accordance with such a reading, the Court's decision seems to leave the door open to a defense of meeting competition, even when price is below cost. Yet a different reading of the decision is also possible, as abuse was assumed based on the fact that the AKZO cost-price test for predatory pricing was fulfilled, without checking whether, in fact, the alignment of prices was necessary to "protect the interests" of the dominant firm and to allow competition on the merit. The rest of this article will show that the first reading is the preferred one, if one's goal is to further competition on the merits. It also attempts to carve out those unique cases in which a below-cost meeting competition defense should be allowed.

### **III. Predation as abusive conduct**

In order to delineate the proper scope of a meeting competition defense in predatory pricing cases, let us take a step back and review the logic behind the predatory pricing prohibition. Predatory pricing is one of the offenses that might create anticompetitive harm by the exclusion of rivals. By weakening rivals and causing them to exit the market or not to enter or expand in it, the dominant firm can enhance or maintain its market position, thereby also harming consumers and the competitive process.

Despite arguments that predatory pricing rarely exists in practice,<sup>17</sup> almost all

---

<sup>11</sup> *France Telecom*, above, para. 171.

<sup>12</sup> *ibid.*, para. 179-181. France Telecom argued that the interim measures in AKZO involved a somewhat similar issue in that the court allowed AKZO to meet the prices charged by a specific competitor. Yet the CFI stated that this defense was not referred to in the final decision and thus cannot be relied upon.

<sup>13</sup> *ibid.*, para. 182.

<sup>14</sup> *ibid.*, para. 185.

<sup>15</sup> *ibid.*, para. 187.

<sup>16</sup> *Wanadoo*, above, para. 315-316. At the same time, however, the Commission also analyzed the meeting competition defense put forward by Wanadoo and rejected it on the facts. It is most likely that the Commission engaged in such analysis just to be cautious, given that the Court has never ruled on the matter before.

<sup>17</sup> See, e.g., Robert Bork, *The Antitrust Paradox* (Basic Books, 1978, reprinted with a new introduction and epilogue, Free Press, MacMillan, 1993), 154; Frank Easterbrook, "Predatory Strategies and Counterstrategies" (1981) 48 *U. Chicago L. Rev.* 263. The U.S. Supreme Court has stated that

economists agree that the theory upon which the offense rests is a sound one. Predatory pricing is a two-staged strategy designed to limit rivalry. In the first stage (the predatory stage) the dominant firm reduces its prices below some threshold, which does not enable the dominant firm's rivals to recover all their costs. This conduct is designed to drive out an existing competitor, to deter its expansion or otherwise weaken him, or to prevent the entry of a potential competitor. The first stage ends when entry or expansion are deterred. In the second stage (the recoupment stage) the dominant firm recoups its losses from the first stage. The monopolist may recoup his investment if a rival exits the market and thereby the demand for his products increases. He might recoup his losses if entry is deterred and thus he can charge higher prices than were possible if entry occurred.<sup>18</sup> He might also benefit from creating a reputation as a predator that might deter future rivals from entering the market. Finally, predation might be profitable if it serves as a punishment device in a concentrated market in order to ensure that competitors stick to the status quo which profits all. Predation thus involves unilateral conduct which inflicts costs on the predator in the short run, but is profitable for him in the long run due to its weakening influence on his rivals.

There has been a rigorous discussion in the economic literature regarding the level of price that should be regarded as predatory. Most agree that price should be below the costs of the dominant firm. As noted above, in *AKZO*<sup>19</sup> the ECJ determined that "prices below average variable costs (that is to say, those which vary depending on the quantities produced) by means of which the dominant undertaking seeks to eliminate a competitor must be regarded as abusive." Price below ATC is predatory if intent to predate is proven. The ECJ emphasized that "[a] dominant firm has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its prices by taking advantage of its monopolistic position, since each sale generates a loss."<sup>20</sup>

The rationale for these rules as put forward by the ECJ is important for our discussion: the predatory pricing prohibition prevents competition based on merit.<sup>21</sup> This is because "[p]redatory prices can drive from the market undertakings which are perhaps as efficient as the dominant undertakings but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them."<sup>22</sup> This rationale fits well with basic competition law principles which suggest that competition law does not protect competitors or even competition as such, but rather protects the dynamics of the competitive process, to ensure that more efficient firms replace less efficient ones. It follows that if a dominant firm is more efficient, and thus its costs are lower than those of its rivals, then prices above cost should not be regarded as abusive, despite the fact that such pricing does not enable less efficient competitors to survive under the price umbrella erected by the dominant firm and may even be harmful to consumers in a static sense.<sup>23</sup> If, however, a pricing strategy

---

"predatory pricing schemes are rarely tried, and even more rarely successful." *Brooke Group* 509 U.S. 209, p. 226.

<sup>18</sup> For such an interpretation of the recoupment requirement see, e.g., Aaron Edlin, "Stopping above-cost predatory pricing" (2001) 111 *Yale L. J.* 941.

<sup>19</sup> *AKZO*, above.

<sup>20</sup> *ibid.*, para. 71. For criticism of this criterion see, e.g., Jones and Sufrin, above, pp. 339-40.

<sup>21</sup> *France Telecom*, above, para. 70.

<sup>22</sup> *ibid.*, para. 72.

<sup>23</sup> For a similar principle see the Discussion Paper, above, para. 63.

excludes firms which are equally or more efficient than the predator, then such conduct should be deemed abusive as it does not result from competition on the merits. As elaborated below, the cost-price test works well to ensure that "as efficient" rivals are not excluded from the market in static models of profit maximization which assume that scale economies, learning curves or network effects are insignificant. They may not be appropriate when such assumptions do not hold true.<sup>24</sup> The law on predatory pricing thus treads a fine line between allowing competitive responses by the dominant firm, on the one hand, and prohibiting unreasonable exclusionary conduct, on the other.<sup>25</sup>

#### **IV: Rule: Meeting competition rejected as an absolute defense**

As noted above, France Telecom argued that its prices should not be considered predatory, even if they were found to be below cost, because it aligned its prices with those of its competitors.<sup>26</sup> This argument is basically a "meeting competition" one. Such an argument arises where a dominant firm is generally prohibited from engaging in a specific conduct, but such conduct might nonetheless be allowed if it is engaged in by the dominant firm's rivals and it needs to align its conduct with that of its rivals in order to compete effectively. For example, a dominant firm might be prohibited from discriminating among consumers. However, if some consumers have better offers from rival firms, then the dominant firm might be allowed to "meet competition" and offer them equivalent trade terms, even if it does not offer such terms to all consumers.<sup>27</sup>

The meeting competition argument rests on the idea that a dominant firm's freedom and ability to compete in the market should not be harmed, relative to its rivals, just because it enjoys a dominant position. This idea serves the market dynamics well. Were we to impose strict restrictions on dominant firms that would reduce their ability to compete on merit, firms would have reduced incentives to become dominant in the first place. Also, less efficient firms might replace efficient ones.

The ability to meet competition does not imply, however, that the dominant firm can engage in any activity, just because its rivals engage in it. This is because it might be that the dominant firm's rivals are using their comparative advantage to compete in the market. If we allow the dominant firm to copy their conduct in all cases, then they might not be able to enjoy their advantage and erode the dominant firm's market power. Note, however, that for such conduct to be successful in driving out a more efficient competitor, the dominant firm should be advantaged in liquidity and/or

---

<sup>24</sup> Joseph Farrell and Michael L. Katz, "Competition or Predation? Consumer Coordination, Strategic Pricing and Price Floors in Network Markets" (2005) LIII *Journal of Industrial Economics* 203. For elaboration see Section V below.

<sup>25</sup> R. Whish, *Competition Law* (Butterworths, 4<sup>th</sup> ed.), p. 646.

<sup>26</sup> The Commission rejected this argument also on a factual basis. *Wanadoo*, above, para. 321-326. The CFI did not refer to these issues in its decision.

<sup>27</sup> It might be argued that such "meeting competition" already falls within the wording of the law, since Article 82(c) requires that the discriminatory conduct not "plac[e] competitors] at a competitive disadvantage." The dominant firm's consumers were at such a disadvantage due to the offers their competitors received from other firms and not because of the dominant firm's conduct. For expansion on the meeting competition defense see, e.g., Martin Andreas Gravengaard, "The Meeting Competition Defence Principle – A Defence for Price Discrimination and Predatory Pricing" (2006) 27(12) *E.C.L.R.* 658.

raising capital or the competitor might not be aware of the strength of his comparative advantage due to imperfect information.

This is, indeed, best illustrated in the predatory pricing case. Let us assume a simple scenario, in which only two firms compete- an incumbent provider and a new entrant. Further assume that the newcomer enjoys a comparative advantage over the dominant firm, and his costs are lower than those of the latter. In order to enter the market and convince consumers to be served by it, the entrant prices his products at prices below the incumbent's costs, but above his own. Now assume that the monopolist is allowed to "meet competition" and price at the entrant's level- i.e., below his own costs. Such a strategy might prevent or severely limit the entry of the more efficient entrant.

Of course, if the entrant is indeed more efficient and he has full information regarding his comparative advantage, then he would hold on until the incumbent, who is losing much money due to the fact that he is pricing below cost, would give up his strategy. The more significant the competitor's comparative advantage, the larger the losses the dominant firm must incur to meet competition, as it must dip deeper below costs to meet the competition's comparative advantage, especially if it is not allowed to price-discriminate among consumers. This argument was raised by Chicago-oriented economists in order to prove the non-profitability of predatory strategies. The problem with this argument is two-fold.<sup>28</sup> First, it assumes that the entrant knows the price level of the dominant firm. If he does not know whether the incumbent is more efficient, then he might be deterred by a misleading signal sent to him by the incumbent. Second, even if the entrant knows that he is more efficient, he might not have the financial ability to survive an extended assault. While the traditional "deep pockets" theory whereby firms with large capital reserves can exclude a small, poorly-resourced rival has generally been discredited, it is still recognized that capital markets are imperfect. Investors' willingness to continue to make funds available can be jeopardized by incorrect price signals on profitability caused by predatory pricing or by the acknowledgement of the incentive of the incumbent to "fight for his life" due to his sunk costs. Financial markets would thus not necessarily back the more efficient entrant. Accordingly, the argument that the market will always correct itself without outside intervention should be rejected. Of course, entrants are not always financially weak. In some cases new entrants are large, established firms operating in other industries that are merely expanding their product base. In such cases the risk of reduced financial backing does not exist.

The ruling of the CFI comports with this economic theory. Indeed, the Court rejected France Telecom's defense that it was "meeting competition" and therefore its conduct should not be regarded as abusive regardless of the level of price.

This ruling also comports with the case law on meeting competition, which recognizes the right of a dominant firm to take reasonable, proportionate measures to protect its commercial interests, including responding to commercial offers on the market in order to maintain its customers.<sup>29</sup> In *Irish Sugar* the CFI conditioned "the protection of the commercial position of an undertaking in a dominant position" in the

---

<sup>28</sup> See, e.g., Easterbrook, above.

<sup>29</sup> For analysis of relevant case law see R O'Donoghue and J Padilla, *The Law and Economics of Article 82 EC* (Hart Publishing, 2006), p. 285.



very least "on criteria of economic efficiency and consistent with the interests of consumers."<sup>30</sup> Irish sugar involved selective price-cutting that was above cost. The case for rejecting the meeting competition defense where price is below cost is even stronger and will generally meet the criteria set by the Court.

The Commission's informal decision in *Digital Undertaking*, which accepted undertakings from a company alleged to abuse its power, also goes along these lines.<sup>31</sup> In order to settle the case, Digital Undertaking agreed to ensure that "all discounted prices will remain above average total costs." Digital reserved the right to grant non-standard price reductions to meet competition but undertook that they would be proportionate and not foreclose or distort competition. It expressly acknowledged that the Commission could initiate proceedings if prices were below its average total costs. The Commission's discussion paper also requires that the meeting competition defense only apply if the strategy is suitable, indispensable and proportionate.<sup>32</sup>

Before we move on to identify cases in which meeting competition below cost should be allowed, let me pause for a moment to reconsider above-cost pricing. Indeed, in most cases, as the ECJ noted, below-cost predation ensures that the most efficient firm serves the market. This is because less-efficient firms cannot survive financially at its cost levels. However, this is not always true. Rather, in some cases above-cost predation can harm the dynamics of the competitive process by deterring more efficient firms from entering and expanding in the market. Beyond issues of imperfect information held by rivals with regard to the costs of the dominant firm, this may occur when the newcomer might not immediately upon entry reduce his costs to their lowest possible levels, which are potentially below those of the dominant firm. This might be the case where markets are characterized by considerable scale or learning economies or network effects. In such cases the entrant might need a large consumer base or sufficient time to learn the workings of the market in order to achieve low price levels. Allowing a dominant firm to charge prices that are above its costs but lower than the current costs of its rival might enable it to nip in the bud this potential source of competition on the merit, at the time when the entrant is most vulnerable. Of course, financial markets may correct this by backing the entrant until his costs are reduced to their lowest possible level, but as noted above such markets have their own limitations and might consider the risk posed by such an endeavor a high one, especially if large investments and lengthy periods are necessary in order to successfully operate in the market.<sup>33</sup> The problem with regulation of such conduct is, however, that it might be difficult to identify the more efficient competitor, and thus intervention in the market might lead to socially harmful decisions. Accordingly, only where it is apparent that the newcomer is significantly more efficient than the incumbent should intervention be contemplated. In all other cases the prohibition

---

<sup>30</sup> *Irish sugar*, supra, para. 189.

<sup>31</sup> Commission Press Release IP/97/868.

<sup>32</sup> Discussion Paper, supra, para. 132.

<sup>33</sup> For a different view see Einer Elhauge, "Why Above-Cost Price Cuts to Drive Out Entrants are not Predatory" (2003) 112 *Yale L. J.* 681. The Commission recognized this problem in its Discussion Paper, above, para. 129.

against selective price cuts,<sup>34</sup> as well as other abuse prohibitions, will serve to lower at least some entry barriers to more efficient firms.

## **V. Exceptions: When Meeting competition should allow otherwise predatory prices**

Even if a "meeting competition" argument should not unconditionally enable a dominant firm to engage in otherwise abusive conduct, the question still remains whether such circumstances exist under which meeting competition might justify a price alignment that would otherwise be considered predatory. One possible reading of the CFI's decision seems to leave the door open to such a defense. The identification of cases which might fit under such a defense is the focus of this section.

It should first be noted that recognition of such cases might seem to create an anomaly.<sup>35</sup> Such an exception would seem fundamentally at odds with the rule against predatory pricing and the strong statements by the Court in AKZO that pricing below AVC is not profit-maximizing without exclusion of rivals and therefore presumed to be based on an exclusionary motive.<sup>36</sup>

Some commentators have thus rejected the meeting competition defense where prices are below the threshold. Areeda and Turner, the two leading American scholars who have first suggested the threshold for predation, have argued that:

"A monopolist may attempt to justify prices below marginal cost by claiming... that he is simply meeting an equally low price of a rival. We conclude, however, that these justifications are either so rarely applicable or of such dubious merit for a monopolist that the presumption of illegality for prices below both marginal costs and average [variable] cost should be conclusive."<sup>37</sup>

This is also the view of the Commission as put forward in the Discussion Paper.<sup>38</sup>

Such an assumption generally holds true when focusing on brick-and-mortar industries, while assuming that the market is mature and scale and learning economies have been exhausted. Yet it is possible to identify unique circumstances in which a categorical rejection of a meeting competition defense when prices are below cost might harm competition on the merits. In such cases additional factors, such as the cost level of rivals, the relative prohibitions imposed on them, or the importance of first-mover advantages are of relevance and should be taken into account in order not

---

<sup>34</sup> See, e.g. Cases C-395 & 396/96 *Compagnie Maritime Belge Transport NV v. Commission* [2000] ECR I-1365.

<sup>35</sup> O'Donoghue and Padilla, above, pp. 286-289.

<sup>36</sup> It is noteworthy that the Court's wording does not necessarily imply a categorical rule, as one can argue that the part of the predation test which states "by means of which the dominant firm seeks to eliminate a competitor" might imply intent.

<sup>37</sup> Phillip E Areeda and Donald F Turner, "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act" (1975) 88 *Harvard L. Rev.* 697; Joseph F Brodley, Patrick Bolton and Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy" (2000) 88 *Georgetown L. J.* 2239, p. 2275.

<sup>38</sup> The Discussion Paper, above, para. 183.

to tie the monopolist's hand behind his back. Indeed, some national cases have allowed dominant firms to meet a rival's below-cost price. In *Berlingske Gratisavisser* the Danish Competition Council found that a dominant newspaper was entitled to sell advertising space below cost if its rival was doing so, in order to protect its consumer base.<sup>39</sup> Allowing a meeting competition defense in such cases enables the court to strike a better balance between prohibiting exclusionary conduct and promoting competition on the merit.

O'Donogue and Padilla recognize the importance of such a defense "where there is evidence that prices below AVC/AAC will lead to long-term profits even if no rival is excluded, i.e., where necessary to achieve an internal efficiency that does not depend on any rival exiting."<sup>40</sup> Although the authors do not provide examples of what they had in mind, one can think of a situation in which a product is being introduced into a market which is characterized by large scale economies or a steep learning curve. It may be profitable for the firm to price below cost in order to reach the point of minimum efficient scale by enlarging its consumer base, even if no rival is excluded. Similarly, if the product is new and not self-explanatory, it might be efficient to familiarize consumers with the benefits of the product by pricing below-cost in the first period. Indeed, in *France Telecom* the defendant argued that economies of scale and learning effects were such as to justify its price levels. The Court rejected the defense and held that an undertaking that charged below-cost "may enjoy economies of scale and learning effects on account of increased production precisely because of such pricing. Such economies and learning effects could not therefore exempt that undertaking from liability."<sup>41</sup> The Court's reasoning seems to categorically reject an efficiency defense based on a long-run profitability calculation by the dominant firm. Rejection of such a defense is problematic, as it does not enable a firm to efficiently build a customer base in a new product market or in one characterized by significant scale economies or learning effects, regardless of the effects on rivals.

I would add another set of circumstances in which the combination of legal rules and the economic characteristics of the market might prohibit an efficient incumbent from protecting its market position based on merit. Such a situation might arise, for example, from a combination of three legal and economic factors. The most important condition is an economic one, which requires that a first-mover advantage can tip the market and create significant entry barriers for lengthy periods that might prevent more efficient firms from entering. This may result, for example, from high switching costs and significant scale economies. In such markets competition on the merits and excluding other competitors do not clash, but are rather the outcome of competition *for* the market. Two legal factors are also relevant: (1) the law imposes upon the dominant firm behavioral limitations which are not imposed on other firms, so that a non-dominant firm might act in a manner which is prohibited from a dominant firm, including pricing its products below costs;<sup>42</sup> (2) the Treaty's provisions do not prohibit monopolization of the market. Rather, it imposes limitations only once a dominant

---

<sup>39</sup> See Annual Report to the OECD on Competition Law and Policy in Denmark 2002, p. 6, <http://www.oecd.org/dataoecd/22/12/2509437.pdf>.

<sup>40</sup> O'Donogue and Padilla, above, p. 286.

<sup>41</sup> *France Telecom*, above, para. 217.

<sup>42</sup> A finding of dominance under Article 82 EC is a pre-requisite for the abuse prohibition. See Case T-111/96 *ITT Promedia v Commission* [1998] ECR II-2937, para. 139.

firm has become so. In newly created markets another legal factor may also be of relevance- that the dominant firm is prohibited from engaging in abusive conduct also in markets in which it does not hold a dominant position. The combination of these factors implies that a newcomer might engage in a predatory strategy that will enable it to oust out a more efficient incumbent.

Such a situation is best explained by an example. Assume that the monopolist operates in a given industry. Further assume that a new industry (thereafter: "the industry") is developing, which is adjacent to the first one. Both the monopolist and a newcomer are competing to supply the industry. Both know that the industry is characterized by significant economies of scale as well as high switching costs which create a strong first-mover advantage. The monopolist's price for supplying each unit in the industry is 1 Euro. The newcomer's price per unit is 1.1 Euros. Both firms are well aware of their rival's cost structure. The newcomer, realizing that the monopolist is constrained by legal prohibitions in his pricing decisions and thus cannot price his products below his own costs, decides to set the price at 0.99 Euros per unit. Although this price is below his own costs, he is not legally limited in his pricing decision since he does not enjoy a dominant position. Moreover, despite the fact that his strategy is designed to create a dominant position, until such a position is created he is not bound by the predatory pricing prohibition. If the monopolist is prevented from "meeting competition" and cannot align his prices with those of his rival, then the outcome would be that the newcomer will enjoy an advantage that might eventually tip the market in his favor, despite the fact that he is less efficient than the monopolist. Once such an advantage is achieved, the newcomer might raise his prices above his own costs, to ensure he is not found to abuse his position.

Network industries complicate this even further. Network industries are characterized by complementarities and consumption externalities which might create high switching costs and significant economies of scale in production.<sup>43</sup> These characteristics create situations in which first-mover advantages are of high importance. Microsoft exemplifies this well. Microsoft's operating system, Windows, enjoys strong network externalities which strengthen Microsoft's existing market position. Network effects exist when the utility derived from the consumption of a good is affected by the number of other people using similar or compatible products.<sup>44</sup> With regard to operating systems, such externalities are of two types. First, computer users benefit from compatibility with programs used in other computers. This is because if they switch to a new work environment (e.g. change jobs) the probability that they will be able to work with a system they are already familiar with is higher. Also, it will be easier to exchange data between compatible programs. These are direct positive consumption effects. Second, indirect positive consumption effects also exist: software developers, recognizing the effects of network externalities on consumers, will have stronger incentives to develop new programs for the incumbent monopolist, as the demand for such programs might be higher than for programs developed for other operating systems. This will also have an aggravating effect on consumers, which will then have an even stronger tendency to buy the incumbent's system as the value of the system increases with the number and quality of applications that run on it. This process thus creates a positive feedback loop which

---

<sup>43</sup> Oz Shy, *The Economics of Network Industries* (Cambridge University Press, 2001), chapter 1.

<sup>44</sup> *ibid.*, 3; Michael L. Katz and Carl Shapiro, "Network Externalities, Competition and Compatibility" (1985) 75 *American Economic Review* 424, p. 424.

strengthens the position of the incumbent. The scope of such externalities is determined by the degree of compatibility of the technologies.<sup>45</sup>

These network effects make it extremely difficult for firms to enter the market with new products and new technologies, since by joining a firm with a smaller installed base and incompatible technology, consumers give up consumption benefits they could have enjoyed on a larger network. In emerging markets, consumer expectations regarding the future size of a firm's installed base are critical to competition, as the more they expect the network to grow, the stronger their willingness to buy the technology.<sup>46</sup> It may thus be beneficial for a firm to set prices below cost for a period of time in order to create consumer expectations that it will have a large consumer base. With such expectations it may well be able to recoup losses from current below-cost pricing.<sup>47</sup> First-mover advantages and expectations of growth thus largely determine the comparative advantages of market players. Once a market-dominating position is achieved, it can thus be quite durable.<sup>48</sup> Thus, markets with strong network effects and incompatible products often tend towards monopoly or tight oligopoly.<sup>49</sup> Indeed, some markets are even characterized by a winner-takes-all competition, due to strong network effects and high substitutability costs.

Such market power is generally legitimate, if it was achieved without breaching the competition laws by erecting artificial barriers to trade once dominance is achieved. Moreover, a tipping effect may raise welfare by increasing network benefits through de facto standardization.<sup>50</sup> Indeed, some commentators have even argued that winner-take-all markets should provide a complete defense against a charge of predatory behavior.<sup>51</sup>

Yet competition policy still has an important role to play, either in encouraging compatibility or in ensuring that the most efficient firm serve the market.<sup>52</sup> The winning of the market by a less efficient firm has important implications for social welfare. First, it may price its product at higher levels than a more efficient firm would, due to its cost structure. Potential entry by a more efficient firm may provide little constraint on price. As Katz and Shapiro show, if A is first in the market, then it will price its product at the value of the benefit of buying from a new rival which is waiting for its installed base to grow. If B's entry is expected in the future, then the later it enters the higher A can price its products. Similarly, the lower B's rate of penetration, the higher A can price its products. Social welfare implications might also extend beyond static considerations involving price levels. Such effects might include limited innovative levels of new products and new production processes. As

---

<sup>45</sup> *ibid.*

<sup>46</sup> M.L. Katz and C. Shapiro, "Product Introduction with Network Externalities" (1992) 40 *Journal of Industrial Economics* 55.

<sup>47</sup> *ibid.*, pp. 65-66.

<sup>48</sup> *ibid.*

<sup>49</sup> Steven C. Salop and R. Craig Romaine, "Preserving Monopoly: Economic Analysis, Legal Standards and Microsoft" (1999) 7 *Geo. Mason L. Rev.* 617.

<sup>50</sup> Farrell and Katz, above, p. 204.

<sup>51</sup> David S. Evans and Richard Schmalensee, "Some Economic Aspects of Antitrust Analysis in Dynamically Competitive Industries" in *NBER/Innovation Policy and the Economy* (MIT Press, 2000, Jaffe, Lerner, and Stern eds.) vol. 2, issue 1; Brodley, Bolton and Riordan, above.

<sup>52</sup> Farrell and Katz, above, p. 226.

has long been recognized, such innovations are often the main source and drive for social welfare.<sup>53</sup>

In such situations it might thus make sense – both on economic and on fairness grounds- to allow the more efficient monopolist to meet competition. Applying such a defense would, however, require the court to recognize the existence of unique circumstances in which the law creates a comparative disadvantage for the dominant firm that not only does not promote competition and efficiency, but rather harms it. This is no easy task, as it requires a detailed factual inquiry in an attempt to identify predatory conduct and differentiate it from intense competition. As Farrell and Katz have argued, distinguishing competition from predation may be even harder in network markets than in others. With inter-temporal increasing returns, there may be intense initial competition as firms fight to make initial sales and benefit from the increasing returns.<sup>54</sup> Yet preventing firms -including dominant ones- from internalizing the benefits of increasing returns to scale may be socially harmful. The price-cost benchmark for predation that is based on current costs might thus have to be changed in order to accommodate the dynamics of such markets. Nonetheless, it is important to create such a test to prevent the creation of artificial barriers to entry.

Allowing such meeting competition by the dominant firm is most rational when the market is first established, or when a high fixed-cost technological shift in the industry occurs, to allow competition on the merit to take place. It may also make sense to allow such a defense when a firm which is dominant in one industry attempts to enter a new market, already dominated by another firm, in which high switching costs coupled with large scale economies require newcomers to charge below-cost prices to locked-in consumers in order to persuade them to change their supplier in order to create a critical consumer base. Yet once a firm already enjoys large market shares in the relevant market and has reached its minimum efficient scale, it has weaker pro-efficiency incentives to price below-cost. In such circumstances a meeting competition defense should rarely apply.

It is noteworthy that another way to tackle this problem is to add to the Treaty a prohibition against monopolization (which in Europe might be termed "dominisation"), that is, conduct which will most likely succeed in creating a dominant position and in the course of so doing harms the competitive process. Such a prohibition exists in the US and serves to solve the gap between the limitations imposed on the unilateral conduct of dominant firms and the fact that no such limitations exist on not-yet dominant enterprises. The logic behind such a prohibition is quite similar to that behind merger review, which also regulates conduct ex ante, in its incipiency, recognizing that once the conduct takes place it would be very difficult to undo its effects. Alternatively, should consumer harm become a necessary condition to prove abuse, as some commentators suggest, then welfare-enhancing below-cost meeting competition would not be prohibited.

A finding of predation thus requires an appreciation of the economic context in which the pricing behaviour takes place, including the strategies of the dominant firm's rivals and their relative costs.

---

<sup>53</sup> In some cases, however, spending on innovations in order to win winner-takes-all markets might be excessive from a social welfare point of view.

<sup>54</sup> Farrell and Katz, above.

It is worth noting that in *France Telecom* it might have been Wanadoo who was seeking to enjoy first-mover advantages. Although the Court does not provide many details regarding the nature of competition in the ADSL market, several facts that can be discerned from the Commission's decision are of relevance. Wanadoo was a subsidiary of France Telecom (70% indirectly owned) which competed, by itself and through its subsidiaries, for the supply of a full range of telecommunications services. In fact, the Commission pointed out to additional types of conduct which granted priority to consumers which purchase ADSL services from Wanadoo over its rivals.<sup>55</sup> Thus, while ADSL markets do not generally exhibit demand-side externalities, they might exhibit scale and scope economies, especially if coupled with other telecommunications services. In addition, strengthening its position in the ADSL market might have strengthened France Telecom's reputation in related service markets. France Telecom thus enjoyed positive externalities from dominating the ADSL market and had a strong incentive to do so. It would have made for an even better analysis, however, if an efficiency justification, involving multi-market marketing pricing, would have been addressed by the Court.<sup>56</sup> However, the Court did not have jurisdiction to deal with such an issue, inter alia, because it was not pleaded by the appellant.

## **Conclusion**

The current move towards a more efficient and economics-oriented approach as applied to Article 82 requires the Commission as well as the courts to "carve out" limitations and conditions for the application of the existing provisions in order to better differentiate use from abuse. As this article attempted to show, the CFI's recent *France Telecom* decision generally advances the refinement of the concept of abuse by prohibiting below-cost meeting competition. A possible reading of the decision further refines it by opening the door- even if only by a crack- to such a meeting competition defense in unique circumstances. Such a defense is important for differentiating exclusionary conduct that simply reflects competition on the merits and inefficient exclusionary conduct. It enables the court to recognize the different characteristics of industries- thereby differentiating established industries from those characterized by high switching costs, network externalities or large scale and learning economies. The article also argued that additional steps can be taken in order to further refine the predation offense, such as adding a recoupment condition to the offense of predation, in order to ensure that the alleged conduct indeed has the effect of harming competition. Hopefully, the courts will do so in future cases.

---

<sup>55</sup> *Wanadoo*, above, para. 140-150.

<sup>56</sup> For an argument along these lines see, e.g., Valentine Korah, "Wanadoo" *Competition L. J.* (2005) 251.