“Wanadoo” a bargain price?

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1. Introduction

Within the conducts which can constitute an abuse of a dominant position under Article 82 of the EC Treaty, predatory pricing is one of the most discussed, primarily from an economic point of view.

Even if commentators do not seem to share a common definition of predation, it generally refers to "the practice where a dominant company lowers its price and thereby deliberately incurs losses or foregoes profits in the short run so as to enable it to eliminate or discipline one or more rivals or to prevent entry by one or more potential rivals thereby hindering the maintenance or the degree of competition still existing in the market or the growth of that competition"[1]. The market shares gained by the dominant undertaking because of the exclusion of actual or potential competitors are the expected set off for the reduced profits, or even losses, suffered in the short-term.

Competition policy seems to impede what it actually should encourage, i.e. low prices deriving from a vigorous competition on price. In fact, the problem with predatory pricing is that in some cases low prices and higher output can be detrimental to consumers' welfare in the medium to long-term. What competition policy must therefore assess is where a strong price competition ends and predatory pricing begins. Since consumers benefit from low prices, competition authorities are asked to clearly and simply set the rules governing the matter, so that to allow firms to widely compete on the merits without discouraging possible price reductions.

There are only few precedents of abuses of dominant position through predatory pricing practices. The present paper aims at describing the general legal and economic framework of predatory pricing in the light of a recent judgment of the Court of First Instance involving the French company France Télécom.

2. The Wanadoo judgment

2.1 Preamble

By decision of 16 July 2003, the Commission found that Wanadoo Interactive SA (Wanadoo) infringed Article 82 EC by charging predatory prices on the market for high-speed internet access for residential customers. The products concerned were internet access service based on ADSL technology, in particular Wanadoo eXtense and ADSL services.

Based on the level of prices charged, the Commission distinguished two phases within the infringement period. During the first period, from March to August 2001, Wanadoo's variable costs were not covered by the prices charged; during the second one, from August 2001 until October 2002, Wanadoo's did not cover its full costs.

[1].DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses, para. 28, available at http://ec.europa.eu/comm/competition/antitrust/art82/discpaper2005.pdf.

At the time of the infringement, Wanadoo was controlled by France Télécom, owning between 70 and 72% of its share capital. France Télécom sought annulment of the decision and was therefore the addressee of the judgment because it succeeded to the rights of Wanadoo following a merger.

On December 30, 2007, the Court of First Instance upheld the analysis of the Commission stating that a predatory pricing practice which does not allow the dominant company to cover either its variable costs or its full costs within a strategic plan aimed at the pre-emption of the relevant market constitutes an abuse of a dominant position.

2.2 The relevant market

The Court of First Instance defined the relevant market as the one of the provision of high-speed Internet access services for residential clients in France. Such definition confirms the distinction followed by the Commission between the markets for the provision of high-speed and low-speed Internet access services respectively.

The identification of two separate markets lies in their differences in use, technical features, performances and price as well as in their degree of substitutability. The Court found that the Commission was right in considering the following elements: some applications available with high-speed access are simply not feasible with low-speed access[2]; the subscriber with high-speed access goes online far more often and, on average, for considerably longer than the low-speed access user[3]; a high-speed internet access modem cannot be used for low-speed internet access and vice versa[4]; in the case of high-speed access, the connection is always on and the telephone line always available for making calls[5]; the high-speed connection allows a higher download speed[6]. As far as the degree of substitutability is concerned, the Commission admitted that low-speed and high-speed access indeed present some degree of substitutability; it concluded, however, that such substitutability is very asymmetrical, given that the migration of customers from the high-speed to the low-speed connection is negligible compared with the migration in the other direction[7].

The market analysis conducted by the Commission in Wanadoo, and upheld by the Court, is consistent with previous results in merger control cases. A first distinction emerged from these precedents was the one concerning the categories of consumers to which internet access services were provided: business clients "big enterprises" on the one side and residential and business clients "small enterprises" on the other[8]. Within this second category, another distinction was made between the narrow band access through the telephone line, and the broadband access through cable or DSL (digital

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[2] Case T-340/03, *France Télécom SA v Commission*, not yet published, OJ C 69 of 24.03.2007, para. 82.

[3] *Ibidem*.

[4] Case T-340/03, *France Télécom SA v Commission*, cit., para. 83.

[5] *Ibidem*.

[6] Case T-340/03, *France Télécom SA v Commission*, cit., para. 84.

[7] Case T-340/03, *France Télécom SA v Commission*, cit., para. 88.

[8] See Commission decision of April 24, 2001, case COMP M.2222, *UGC/Liberty Media*, para. 13 and Commission decision of March 27, 2000, case COMP M.1838, *BT/Esat*, para. 7.

subscriber line). As highlighted by the Commission, the speed and the "always on" connection characterizing the broadband access offer to the customers a wider range of services and a permanent Internet access. More recently, with the spread of the new Internet broadband access technologies, the Commission considered it not necessary anymore to distinguish between the demand from residential and business clients, unless particular needs are involved.

2.3 The dominant position of Wanadoo

According to consistent case law, a dominant position relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately its consumers[9].

The Community authorities normally assess the power of undertakings by looking at their market share on the relevant market and then on other factors which may indicate that an undertaking is dominant. Save in exceptional circumstances, very large shares are in themselves evidence of the existence of a dominant position[10]. Furthermore, not only monopolists are in a dominant position: a certain degree of competition can well coexist with the presence of a dominant undertaking on a certain market. Even the existence of a lively competition does not rule out the possibility that there is a dominant position on that market and this is so because "the predominant feature of such a position is the ability of the undertaking concerned to act without having to take account of this competition in its market strategy and without for that reason suffering detrimental effects from such behaviour"[11].

In Wanadoo the applicant claimed that market power cannot be assessed on the basis of market shares on an emerging market. According to Wanadoo, the number of potential subscribers to the service and the absence of substantial barriers to entry offered many chances for new players to face the market and this situation showed how Wanadoo could not hold a dominant position[12].

The Court first considered the high market shares held by the applicant during the relevant period. According to the Commission's findings, Wanadoo's market shares ranged from a minimum of 50% (on 31 March 2001) to a maximum of 72% (on 31 March 2002). Notwithstanding a drop between August and October 2002, with figures between 63.4 and 71%, Wanadoo still held large market shares clearly indicating a

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[9] Case 27/76, *United Brands Co and United Brands Continental BV* v. *Commission* [1978] ECR 207, para. 65 and case 85/76, *Hoffmann-La Roche & Co AG* v *Commission* [1979] ECR 461.

[10] Case 85/76, *Hoffmann-La Roche & Co AG* v *Commission*, cit., para. 41.

[11] *Ibidem*.

[12] "Market power cannot be assessed on the basis of market shares on an emerging market. Such a market should be looked at from a dynamic perspective, in order to assess not only actual but also potential competition. According to WIN, the number of potential subscribers is very important given the underequipment of French households. WIN considers that it has shown that new players have emerged on the market and that offers, accompanied by lower prices, have proliferated". See case T-340/03, *France Télécom SA v Commission*, para. 93.

dominant position. As regards the contention that market shares are not a reliable indicator in the context of an emerging market, the Court considered that "(…) by March 2001, the starting date of the infringement according to the Commission, the market concerned had certainly gone beyond the launch or experimental phase"[13]. Even if the market concerned was admittedly a fast-growing market, this cannot preclude the application of the competition rules, and in particular of Article 82 EC. In the Court's opinion, the Commission was therefore right in excluding from the infringement period the start-up phase from its analysis, given that the market had until then not developed sufficiently for a test of predation to be significant.

Other elements were also taken into account for the analysis of Wanadoo's dominant position. In particular, the Court highlighted the vertical integration of Wanadoo in the France Télécom group. The Court took the view that it had enjoyed "considerable advantages", of commercial and technical nature, as compared to other operators in the same sector. The Commission had found that "(…) whatever the ability of the groups in question to support the investments and commercial initiatives of their French subsidiaries, none of them could claim to provide those subsidiaries with a technical and logistical link-up, and a link up in terms of a commercial network in France, capable of impacting on the market as much as those provided by France Télécom to WIN"[14]. Such advantages were recognized in France Télécom being the incumbent telecommunications operators in France; in the network of France Télécom's shops which distributed Wanadoo's products all over France, and in the preferential treatment received by the subsidiary in terms of technical advantages.

On the contrary, the Court excluded the presence of the applicant in the very lucrative market of provision of directories as an element corroborating the dominant position of Wanadoo in the different market of high-speed Internet access services.

3. An overview of the economic framework of predatory pricing.

3.1 Main cost tests for predatory pricing.

Different economic approaches are possible for identifying predatory pricing. The most common theories in case law can be summarized as follows.

[13] Case T-340/03, *France Télécom SA v Commission*, cit., par. 106. The Court's analysis continues by pointing out that "(…) the high-speed access market began its development in France from 1997. WIN's ADSL services and the first offers of its competitors were launched on a commercial basis at the end of 1999. At the end of June 2000, the market for high-speed internet access for residential customers in France already numbered around 100,000 subscribers, and, by the end of 2000, this figure exceeded 180,000. In the first four months of 2001, the market gained more than 5,000 new subscribers per week".

[14] Case T-340/03, *France Télécom SA v Commission*, cit., para. 113.

3.1.1 The Areeda and Turner AVC test

Under this test, a price lower than reasonably anticipated short-run marginal cost (MC)[15] is predatory. Given that marginal cost is difficult to measure, Areeda and Turner suggested using average variable cost (AVC)[16] instead.

The test provoked a lively debate among economists and lawyers and even if it gained the most acceptance, it was criticized in important respects. First, variable and fixed costs are not always easy to distinguish; firms not only take into account short-run variable costs but also medium to long-run variable costs in order to determine their prices; some above MC-level pricing may also be predatory, as in the case of "limit pricig"[17]; finally, in certain markets (such as those involving intellectual property and networks or those of the new economy) AVC may be negligible.

3.1.2 The avoidable cost test

This test utilizes the average avoidable cost (AAC)[18]. In general terms, the test examines whether a firm would save more money by exiting the market entirely than it would gain by remaining in the market at current prices[19].

AAC includes all variable costs and also fixed costs that are not sunk, i.e. all costs that could be avoided by exiting the market. It is assumed that a rational undertaking would not price under AAC because it would be cheaper not to operate in the market anymore: selling under AAC is presumed irrational and, therefore, predatory.

3.1.3 Long-run average incremental cost test (LRAIC)

LRAIC is "the firm's total production cost (including the product), less what the firm's total cost would have been had it not produced the product, divided by the quantity of the product produced"[20]. It represents the total costs (including the sunk costs) needed to enter a market supplying a specific product.

Under this test, however, pricing below LRAIC is not sufficient to infer a predatory pricing policy. Indeed, firms will sometimes price below LRAIC once they have entered the market, because sunk costs do not usually affect production decisions for ever. Once sunk costs are past, it may be more profitable to ignore them and stay in the market.

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[15] Marginal cost is the cost of producing one additional unit of output.

[16] Average variable cost is the variable cost involved in the production of one unit (*i.e.* the variable costs added up and divided by the number of units produced).

[17] Limit pricing is a deterrence strategy aimed at potential entrants rather than existing competitors. It involves the creation of excess capacity by the dominant firm so that to discourage entrants without lowering prices, for if entry is attempted it can increase its production and lower its price without going below cost.

[18] Average avoidable cost involves comparing the incremental cost of remaining in the market with the decremental, or voidable, cost of exiting it.

[19] R. O'Donoghue and J. A. Padilla, *The Law and Economics of Art. 82 EC*, Hurt Publishing 2006, chapter 5.

[20] O'Donoghue and Padilla, *cit.*, chapter 5.

A profit-maximizing firm will not only take into consideration a maximization of its profit in the short time, but also in the long time by ensuring that revenue exceeds long-run marginal costs. LRAIC is said to be a better standard because it "(1) includes all product-specific costs incurred in the research, development, and marketing of the allegedly predatory output, even if they were sunk; (2) avoids the need to classify costs as fixed or variable, which is sometimes complex and arbitrary; (3) does not require courts to allocate joint and common costs, which is a significant problem in practice; (4) includes any costs incurred to effectuate the predatory scheme following formation of the predatory strategy; and (5) measures the present worth of the productive assets by replacement costs, and not by historic costs, which may not correspond with current value"[21].

For all the abovementioned reasons, LRAIC has been widely applied by the Commission and the national competition authorities in cases related to regulated markets, where sunk costs are usually an important cast of market entry.

4. An overview of the legal framework of predatory pricing.

4.1 The "AKZO rules".

The Commission first considered predatory pricing in AKZO[22].

In its judgement the Court set out a structured, cost-based test for identifying predatory pricing. First, the Court stated that "prices below average variable costs (that is to say, those which vary depending on the quantities produced) by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive"[23]. Second, "prices below average total cost, that is to say, fixed costs plus variable costs, but above average variable costs, must be regarded as abusive if they are determined as part of a plan for eliminating a competitor"[24]. It is the second Akzo rule that more differs from the Areeda-Turner test. Under this test, in fact, pricing above AVC does not imply any predation.

The first Akzo rule finds its basic rationale in the fact that a firm's revenues should at least exceed the costs that vary with output. There is in fact no profit-maximizing reason for pricing below AVC and their only possible explanation seems the intent to drive competitors out of the market. Legitimate explanations for prices below AVC may however exist, and indeed the Court dealt with them in some cases (see paragraph 4.6 infra). It is therefore more correct to state the rule as setting out a

[21] O'Donoghue and Padilla, *cit.*, chapter 5.

[22] Case C-62/86, *Akzo Chemie BV v. Commission* [1991] ECR I-3359. Akzo was a multinational chemical company producing benzoyl peroxide for the plastic sector. ECS was a small UK based company also producing benzoyl peroxide, but concentrating in the flour sector (benzoyl peroxide is used as a bleaching agent in flour-milling). As ECS showed its intention to enter the plastic market, Akzo first threatened and then started supplying benzoyl peroxide to the UK at low prices, offering large discounts to ECS's customers. The Commission found that Akzo had abused its dominant position in the benzoyl peroxide market as a whole, pursuing a predation policy against ECS contrary to Article 82 EC.

[23] *Ibid.*, para. 71.

[24] *Ibid.*, para. 72.

presumption of predation when prices are below AVC, which can be rebutted in certain cases.

As for the second Akzo rule, there may be many reasons why a firm might price below ATC (e.g., a shortfall in demand). As a consequence, the Commission is supposed to prove the existence of a plan to eliminate competitors. The Commission can rely on two main types of evidence, a direct or indirect evidence of intent.

Direct evidence of a predatory strategy can consist of "documents from the dominant company, such as a detailed plan demonstrating the use of predatory prices to exclude a rival, or prevent entry or to pre-empt the emergence of a market, or evidence of concrete threats of predatory action"[25]. Where such an evidence is clear cut about the predatory intent, no other elements are required in order to corroborate the fact that its pricing policy does or will impede profitable competition on the market.

Indirect evidence comprises factors that, taken together, show the anticompetitive aim lying behind the price-cutting. The crucial point in offering indirect evidence of intent is that there must be sound and consistent evidence that the pricing policy of the firm does not make any sense if not part of a predatory strategy and that there are no other reasonable explanations for it[26]. This being the case, such will normally suffice to show a plausible strategy to predate and it will not be necessary to show that a foreclosure effect is likely.

In Akzo the court relied both in direct and indirect evidence of a predatory intent. Direct evidence of intent was found by the Court from documents showing a detailed plan by the dominant undertaking to force ECS out of the market and from threats that ECS would have faced retaliation if it did not exit the additives sector. Indirect evidence was found in selective price cuts to ECS's customers and in AKZO subsidising of price cuts in the flour sector by transfer prices from the plastic one.

In Wanadoo the Court had to provide strong evidence of the existence of a pre-emption strategy by the dominant firm for the period from August 2001 until October 2002. The Court upheld the findings of the Commission mostly based on documentary evidence. In paragraph 199 of the judgment, reference is made to internal company documents such as an electronic mail, a framework letter, a presentation and a strategic plan, all of which attesting the existence of a strategy of pre-emption for the high speed market. In addition, the Court recognised that such an intent was reinforced also by other evidence, i.e. the fact that Wanadoo "knew that its non-profitable pricing strategy combined with high sales volumes was not economically sustainable for its

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[25] DG Competition discussion paper, *cit.*, para. 113.

[26] As pointed out by the Commission in the discussion paper, also the following elements will be of relevance to show a plausible predatory policy: is there an actual or likely exclusionary effect, the scale, duration and continuity of the low pricing, does the dominant company actually incur specific costs in order for instance to expand capacity which enables it to react to entry, are certain customers selectively targeted, is there concurrent application of other exclusionary practices, does the dominant company have the possibility to off-set its losses with profits earned on other sales, does it have the possibility to recoup the losses in the foreseeable future through (a return to) high prices, can predation on one market have a reputation effect on other markets, is the prey particularly dependent on external financing and does the prey have counter strategies.

competitors"; it also "knew that the impossibility of matching its retail prices without suffering losses prevented AOL's entry on the high-speed market" and, finally that the claimant "had analysed in detail the advantages which it enjoyed as market leader"[27]. In the light of the above, the Court concluded that "it must be held that the Commission furnished solid and consistent evidence as to the existence of a plan of predation for the entire infringement period"[28].

In Wanadoo the Commission showed a more lenient approach to intent evidence. Actually, it seemed to distinguish internal documents on the basis of their source, attaching more value to those coming from management-level staff (capable of influence on the company's decision making process) or expressed in the context of formal presentations, rather than to those expressed by sales staff or part of informal remarks. Moreover, the Commission was able to infer the existence of a predation policy from an overall evaluation of a bunch of documents considered as a whole, not focusing on some isolated ones.

4.2 What about recoupment?

The question is whether a possibility or likelihood of recoupment is part of the test for predatory pricing. In particular, recoupment is a defence that can be put forward by the dominant undertaking to show that, even in the presence of alleged predatory prices, no harm occurred to consumers due to the impossibility for the alleged predator to recover the losses incurred.

In the leading case Tetra Pack II[29] and, more recently, in Wanadoo the European Courts answered in the negative[30].

In Tetra Pack II[31] the Court emphasized that it would not be appropriate, in the circumstances of the case, "to require in addition proof that Tetra Pack had a realistic chance of recouping its losses. It must be possible to penalize predatory pricing whenever there is a risk that competitors will be eliminated. (…) The aim pursued, which is to maintain undistorted competition, rules out waiting until such a strategy leads to the actual elimination of competitors"[32].

In Wanadoo the alleged predator advanced that the Commission had to provide evidence of the recoupment. As the applicant pointed out, a new economy market was involved in the dispute, i.e. the market for high-speed internet access, where competition's features are very different as compared to those examined under previous cases involving predation. In the applicant's opinion, such market is characterized by low entry barriers, a robust growth and numerous actual and potential new entrants. A

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[27] *Ibid.*, paras. 209-213.
[28] *Ibid.*, paras. 215.
[29] Case C-333/94, *Tetra Pack International SA* v. *Commission*, 1996, ECR I-5951.
[30] See also DG Competition discussion paper, *cit.*, para. 122.
[31] Tetra Pack was found to have abused its dominant position in the aseptic carton market, *inter alia*, through predatory pricing in another with close associative links, i.e. the non-aseptic carton market. This included selling below AVC in Italy.
[32] See case C-333/94, *cit.*, para. 44.

company active in such market cannot likely aim at recouping the losses incurred in the short run. Even imaging the dominant undertaking increasing its prices in the medium to long-term to a level enabling it to recoup its losses, it would stimulate the entry of new operators. In this context, it would not be rational for the company to engage in a predatory policy and, therefore, the explanation for its behaviour should not be laid in a predatory strategy. The Court of First Instance held that "the Commission was therefore able to regard as abusive prices below average variable costs. In that case, the eliminatory nature of such pricing is presumed (…). In relation to full costs, the Commission had to provide evidence that WIN's predatory pricing formed part of a plan to pre-empt the market. In the two situations it was not necessary to establish in addition proof that WIN had a realistic chance of recouping its losses"[33].

The Commission had undertook a detailed analysis of whether recoupment was probable for Wanadoo and it had concluded that it was. In particular, the Commission had concentrated on whether the obstacles to entry guarantee to the dominant undertaking the maintenance in the long-term of a significant degree of market power. The higher these barriers, the more likely the recoupment chances. On the facts, the Commission had identified various barriers to entry, and namely (i) many disincentives to switching subscribers on the part of existing customers; (ii) high costs of entering and acquiring critical size in the broadband market; (iii) self-building of the upstream infrastructure needed for a broadband network was not viable; and (iv) Wanadoo was well on its way to restoring profitable margins, whereas new entrants were not[34].

This analysis is consistent with the content of paragraph 122 of the discussion paper, where the Commission states that "it will in general be sufficient to show the likelihood of recoupment by investigating the entry barriers to the market, the (strengthened) position of the company and foreseeable changes to the future structure of the market. As dominance is already established this normally means that entry barriers are sufficiently high to presume the possibility to recoup. The Commission does therefore not consider it is necessary to provide further separate proof of recoupment in order to find and abuse"[35]

It is further to note that the discussion paper seems to recognize that recoupment is unlikely where the predatory strategy takes place in a market characterized by a vigorous competition and that the reduction in the number of operators does not necessarily entail the recoupment of losses. At point 97 of the discussion paper the Commission states that "in a competitive market with many competitors the exclusion of some of them will in general not lead to a sufficient weakening of competition so as to allow the predator to recoup the investment. Also in a market with only a few but strong competitors such an exclusionary strategy is unlikely to succeed"[36]. In the light of these statements, it could be inferred that the predatory strategy might not be seen as rationally aimed at eliminating other competitors whenever the impossibility or

[33] T-340/03, *France Télécom SA v Commission*, cit., para. 227.
[34] See case COMP/38.233, *Wanadoo Interactive*, Commission decision of July 16, 2003, paras. 334, 338.
[35] See discussion paper, para. 122.
[36] DG Competition discussion paper, *cit.*, para. 97.

unlikelihood of the recoupment was known or foreseeable to the dominant company at the time of the setting of predatory prices.

4.3 High fixed costs and low variable costs

Some industries are characterized by high fixed (or capital) costs and low variable costs. This is the case of network industries (e.g. telecommunications, post, energy), and industries involving intellectual property rights. Some commentators argue that the AVC test is not suitable for a proper assessment of the costs incurred by a company in entering such a market and remaining in it. As already mentioned above, the preferred standard is the LRAIC test.

The use of LRAIC has been endorsed by the Commission in its Notice on the application of the competition rules to access agreements in the telecommunications sector[37]. The Commission recognizes that "cost structure in network industries tend to be quite different to most other industries since the former have much larger common and joint costs"[38]. The Commission further considers that "to apply the AKZO test to prices which are to be applied over time by an operator, and which will form the basis of that operator's decisions to invest, the costs considered should include the total costs which are incremental to the provision of the service. In analysing the situation, consideration will have to be given to the appropriate time frame over which costs should be analysed. In most cases, there is reason to believe that neither the very short nor very long run are appropriate. In these circumstances, the Commission will often need to examine the average incremental costs of providing a service, and may need to examine average incremental costs over a longer period than one year"[39].

This approach is confirmed in the Discussion Paper, where the Commission confirms the opportunity of its practice to deviate from the use of the AAC test under certain circumstances. In particular, the use of the LRAIC benchmark in order to define the price under which predation is presumed, is considered to be the appropriate choice in (1) cases concerning activities protected by a legal monopoly and (2) in cases concerning sectors which recently have been liberalized or which are undergoing a liberalization, such as the telecom sector[40].

4.3.1 Legal monopolies

As regards legal monopolies, it is considered that a company dominant in the protected market should not be allowed to cross-subsidiasation, i.e. to use funds generated from the protected market to fund activities in another, often related, area of its activities open to free competition. It is required to the dominant company to recover

[37] Notice on the application of the competition rules to access agreements in the telecommunications sector, OI 1998 C 265/2.
[38] See Notice on the application of the competition rules to access agreements in the telecommunications sector, *cit.*, par. 113. The Commission also highlights that in the case of the provision of telecommunications services, a price which equates to the variable cost of a service may be substantially lower than the price the operator needs in order to cover the cost of providing the service (see para. 114).
[39] *Ibidem*, paras. 114 and 115.
[40] DG Competition discussion paper, *cit.*, paras. 124-126.

in the free market at least all the variable and fixed costs afforded, in other words to price above LRAIC[41].

Deutsche Post AG[42] was the first case in which the Commission expressly dealt with cross-subsidiasation. The case involved a statutory monopoly granted in Germany to Deutsche Post AG over the basic letter post. The company also had a universal service obligation in over the counter parcel services, where parcels are brought by individuals to the post office. Deutsche Post AG was also active in the market of mail-order parcel, which was a free market open to competitors. UPS, a competitor in the mail-order parcels sector, complained to the Commission, *inter alia*, that Deutsche Post AG was subsidizing the mail-order parcel sector with revenues from the monopoly.

One of the most crucial points was the benchmark to be applied for the test of predation. The Commission first identified the "incremental cost", i.e. the one comprising costs incurred in providing the specific mail-order parcel service and not including the fixed costs shared with the provision of other services in the protected market. The Commission thus relied on a LRAIC benchmark to calculate the product specific costs. The incremental cost is in fact different from the costs thresholds in the AKZO test: the first includes fixed as well as variable costs, whilst the second only takes account of variable costs[43].

The Commission found that in the period 1990 to 1995 Deutsche Post AG's revenue from mail-order parcels was below the incremental costs of providing this specific service. More particularly, every sale in the said market represented a loss and in the medium term, such a pricing policy was not in the carriers' own economic interest[44].

4.3.2 Liberalized sectors

It is presumed that pricing below LRAIC is predatory in cases involving liberalized sectors or sectors which are undergoing a liberalization process. The rationale beyond the protection of such markets lies in the need not to undermine the liberalization efforts through predatory behaviors from those companies which had previous monopoly positions.

As the Commission put it, "in order to trade a service or group of services profitably, an operator must adopt a pricing strategy whereby its total additional costs in providing that service or group of services are covered by the additional revenues earned as a result of the provision of that service or group of services. Where a dominant

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[41] It is to note that the Commission's statements lead to the conclusion that cross-subsidisation is mainly relevant where the source of the subsidy is a legal monopoly ad that monopoly is used to fund predatory pricing on a non-reserved market.
[42] *Deutsche Post AG*, OJ 2001 L 125/27.
[43] The Commission pointed out that "(...) when establishing whether the incremental costs incurred in providing mail-order parcel services are covered, the additional costs of producing that service, incurred solely as a result of providing the service, must be distinguished from the common fixed costs, which are not incurred solely as a result of this service". See *Deutsche Post AG*, *cit.*, para. 7.
[44] *Ibid.*, para. 36.

operator sets a price for a particular product or service which is below its average total costs of providing that service, the operator should justify the price in commercial terms: a dominant operator which would benefit from such a pricing policy only if one or more of its competitors was weakened would be committing an abuse”[45].

4.4 Start-up losses

Some industries afford large up-front investments and the need to acquire customers at an early stage. If costs were only assessed at this initial stage they could suggest the product was loss-making whereas, over time, the product may in fact be profitable[46]. The problem is thus to assess how these losses should be treated under Article 82 EC.

Commentators offered different approaches to the problem, which can be used cumulatively.

First, the start-up period can be excluded from the calculation of costs. This is what happened in Wanadoo, where the Commission excluded from the assessment of losses a period of fourteen months because the market for high-speed Internet access had not developed sufficiently for a test of predation to be significant[47].

Second, a depreciation of the value of assets over their useful time may be possible. Under this approach, assets are not necessarily a fixed expense, mainly because they wear out over time or through intensity of use. In Wanadoo the Commission considered that customers’ acquisition costs (e.g. supply of free modems) were not only an immediate expense for the company but also a commercial investment, to be written off over the estimated duration of the customer’s subscription. Thus the Commission spread such costs over a four year period, based on the finding that it was not in the company’s intention to produce an immediate profit but to achieve a return on its investment within a reasonable time[48].

Third, it is possible to apply standard techniques used to measure cash flow over time in the context of investment-making decisions. The most commonly used method is the discounted cash flow (DCF). This method consists in the forecast of future revenues and costs and in the subsequent discount of the same at the appropriately adjusted discount rate in order to add them up to yield a single net present value (NPV) figure. If the NPV is positive then the project is worth a tentative; if the NVP is negative then it is better not to undertake it[49]. A DCF approach was considered in Wanadoo but rejected for several reasons and, in particular, because it does not allow any conclusion

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[45] See Notice on the application of the competition rules to access agreements in the telecommunications sector, *cit.*, para. 113 and discussion paper, *cit.*, para. 126.
[46] O’Donoghue and Padilla, *cit.*, chapter 5.
[47] Case COMP/38.233 Wanadoo Interactive, *cit.*, para. 112.
[48] It is to note that the mentioned approach corresponds with the argument made by some commentators that the AVC test does not need modifications in the case of products with very low AVC if the proper time period is taken into account. See O’Donoghue and Padilla, *cit.*, chapter 5.
[49] O’Donoghue and Padilla, *cit.*, chapter 5.

as to predation. Moreover, the use of such method, proposed by the defendant in a non traditional variation, was not supported by Community case law or by the Commission's previous decisions. As a matter of fact, the analysis does not allow a distinction between situations where positive margins are due to legitimate pricing and situations where the only reason for the profits is the exclusion of competitors. Moreover, there are often accounting problems because the information available may not allow a proper *ex post* reconstruction of anticipated revenue flows[50].

Fourth, and finally, an *ex ante* evaluation of the possible profitability is possible on the basis of reasonable and plausible assumptions applied to the information available to the firm. In Wanadoo the Commission used this method only as a double check for its conclusion that Wanadoo's pricing policy was predatory[51].

4.5 The recovery of costs test in Wanadoo

As regards the costs test to be taken into account, Wanadoo submitted results based on the method of discounted cash flows (DCF) in order to calculate the discounted net value of subscribers, according to which, as already noted, the revenues and costs generated for every subscriber must be discounted at the rate determined by the financial markets. The Commission submitted instead a "dynamic method" based on adjusted costs, which takes account of the fact that certain items of variable costs, and in particular those linked to the acquisition of a subscriber, are offset by revenues that the undertaking reckons that it will obtain from that subscriber over the course of the commercial relationship. As already noted, the Commission spread the variable non-recurrent costs over 48 months, taking into account the duration of the typical lifetime of a subscription which could serve as a point of reference for an undertaking seeking a return on its investment within a reasonable period[52].

The Commission then considered that Wanadoo's objective "(…) was not to produce an instantaneous profit but to achieve a level of recovery of recurrent costs (network costs and production costs) which is sufficient to ensure that the margin between revenue and recurrent costs will, within a reasonable time, also cover the non-recurrent variable costs invested in the commercial development of the particular product". The Commission thus decided to spread the costs of acquiring customers over 48 months.

In applying this method the Commission reached the conclusion that Wanadoo's prices were below AVC during the first period and below ATC during the second.

The Court upheld the Commission's legitimate application of the adjusted costs test and, in rejecting all of Wanadoo's allegations, took the view that even if Wanadoo "were to prove that the method which it advocates is appropriate in some respects, this

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[50] *Ibidem*.

[51] "(...) according to the decision, that analysis only seeks to throw further light on the matter and no more", see T-340/03, *France Télécom SA v Commission*, cit, para. 133.

[52] T-340/03, *France Télécom SA v Commission*, cit, paras. 125-126.

would be insufficient to prove that the method used by the Commission in the present case is unlawful. It is for the applicant to prove that unlawfulness"[53].

4.6 Objective justifications

According to consistent case law[54] and leading commentators[55], even prices below AVC (and *a fortiori* those above AVC but below ATC) may in certain circumstances have a legitimate justification. This conclusion derives from practical considerations linked to the difficulties in costs calculations based on the AVC test; also, the emergence of new-economy markets, where exclusion may be a necessary and pro-competitive feature of market development, at least at an early stage, also contributed to an indication that a more nuanced approach in the application of Article 82 EC may be plausible; finally, a strict adherence to cost-based tests has shown to be sometimes inappropriate and, on the contrary, a strategy-based approach more coherent.

A basic distinction has been drawn between justifications that are defensive in nature, i.e. intended to respond to rivals' behaviors, and justifications based on offensive or market-expanding efficiencies. The following objective justifications have acquired a significant role in the assessment of a predatory pricing policy: 1) meeting competition; 2) short-term promotional offers; 3) market-expanding efficiencies (such as scale economies, learning by doing, and forward-pricing); 4) loss-leading; 5) loss-minimising, and 6) miscellaneous defences such as mistake and obsolescence.

The following paragraphs will furnish a brief description of those defences relevant to the Wanadoo judgment.

4.6.1 Meeting competition defence

A change in market conditions could be provoked by entry by a rival. If the prices set by rivals are lower than those of the dominant firm, then the latter may invoke the meeting competition defence, to the extent that this is the response that minimizes its short run losses[56].

A distinction must be made between defensive price cuts below AVC and those that are above AVC but below ATC. As the Discussion Paper points out, "in case the pricing abuse concerns pricing below AAC the meeting competition defence can normally not be applied. Pricing below AAC is in general neither suitable nor indispensable to minimize the dominant company's losses"[57]. As emphasized by some authors, however, selling below AVC should be permitted where there is a genuine price war with rivals and where "option values" or "real options" are involved[58]. As regards

[53] T-340/03, *France Télécom SA v Commission*, cit., para. 153.
[54] See case T-83/91, *Tetra Pack International SA* v. *Commission* [1994] ECR II-755, para. 147 and case *AKZO Chemie BV* v. *Commission*, cit., para. 156.
[55] See, *inter alia*, J. Faull & A. Nikpay, *The EC law of competition*, IInd Ed., Oxford University Press, 2007, para. 4.287.
[56] DG Competition discussion paper, *cit.*, para. 132.
[57] DG Competition discussion paper, *cit.*, para. 132.
[58] O'Donoghue and Padilla, *cit.*, chapter 5. The authors point out that " (…) in many cases there may be a value of retaining the option of staying in the market if there is a reasonable prospect that, in the near future, revenues will exceed costs. For

pricing above AVC but below ATC, the Discussion Paper says that the meeting competition defence will only apply if it is shown that the response is suitable, indispensable and proportionate. This requires that "there are no other less anti-competitive means to minimize the losses and that the conduct is limites in time to the absolute minimum and does not significantly delay or hamper entry or expansion by competitors"[59].

In Wanadoo the applicant put forward the meeting competition defence referring to a previous decision of the Commission[60] and to the AKZO case.

The Commission's position was that the right of a dominant undertaking to align its prices on those of competitors is not absolute, being it not permitted to align prices where the costs of the service in question would not be recovered by the dominant firm.

In analyzing the compatibility of such position with Community law, the Court first recalled that "the fact that an undertaking is in a dominant position cannot deprive it of its entitlement to protect its own commercial interests when they are attacked, and (…) such an undertaking must be allowed the right to take such reasonable steps as it deems appropriate to protect those interests. However, such behavior cannot be countenanced if its actual purpose is to strengthen this dominant position and abuse it"[61]. Citing the specific obligations imposed on undertakings in a dominant position, the Court pointed out that the latter may be asked, in specific circumstances, to refrain from adopting a course of conduct which is not in itself an abuse and which would also be unobjectionable if adopted by a non-dominant firm. It derived from the foregoing that Wanadoo could not have relied on an absolute right to align its prices on those of its competitors in order to justify its conduct[62].

4.6.2 Market-expanding efficiencies

As mentioned before *sub* paragraph 4.4, in new and emerging markets efficiencies can only be achieved over time. These markets usually require large up-front investments and start-up losses aimed at acquiring customers, experience and capabilities which will allow a reduction of costs over time. These characteristics are more likely to justify below-cost pricing on the assumption that there are non-exclusionary reasons for it. Among the efficiencies which can lead to a reduction of costs over time, scale/scope economies, market education, learning by doing and network effects are worth mentioning.

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example, in markets such as broadband Internet and third generation mobile telephony, many suppliers are losing money, but see a strong option value in remaining in the market in order to take advantage of future revenue streams from multimedia and other applications. The size and timing of these revenues may not be precise, but they are nonetheless real in terms of sources of value in a commercial venture. Projects often comprise a multitude of possible actions that can give rise to valuable real options".

[59] DG Competition discussion paper, cit., para. 132.

[60] Decision 83/462/EEC of 29 July 1983, *ECS/AKZO* interim measures, OJ 1983 L 252, p. 13.

[61] See case *United Brands Company and United Brands Continental BV* [1978] ECR 207, p. 189.

[62] T-340/03, *France Télécom SA v Commission*, cit., para. 187.

The Commission's attitude towards this objective defence is not entirely clear. In the Discussion Paper the Commission first states that temporary prices under AAC may be justified in cases where there is an issue of strong learning effects[63]; it further considers, however, that "an efficiency defence can in general not be applied to predatory pricing. It is highly unlikely that clear efficiencies from predation can be shown and even when they exist that predation is the least restrictive way to achieve them"[64].

In Wanadoo, as already observed, the start-up losses incurred by the company were not only aimed at entering the market but they were part of an express plan of incurring whatever losses were necessary to pre-empt the market. As some commentators put it, strong reliance on extensive documentary evidence of exclusionary intent, probable recoupment, and actual or likely exclusionary effects suggests that a high evidentiary thresholds applies before start-up losses can be found to be predatory[65].

5. Conclusions

The Wanadoo judgment reflects to some extent the difficulties raised by the discussion paper on the application of Article 82 EC, in particular with reference to the "effects-based approach".

The analysis of recoupment seems particularly interesting. As mentioned, the Court upheld the view of the Commission that proof of recoupment of losses is not a precondition to making a finding of predatory pricing.

As a matter of fact, however, predatory pricing claims have in practice only succeeded under Article 82 EC where recoupment was either actually established or probable in the facts. Moreover, even in the absence of a formal recoupment requirement under Article 82 EC, other current practices allow this "weakness" in the law to be almost satisfactorily filled. First, the prohibition of predatory pricing under EC law only applies to companies in a dominant position, where in jurisdictions requiring evidence of recoupment (e.g. United States[66]) the law does not require a pre-existing position of dominance but a conduct creating or threatening to create a monopolization. Second, and more importantly, where the Commission carries on an analysis of the effects on competition in predatory pricing cases, then this approach would be similar in substance to the application of a recoupment condition[67].

After affirming that an approach based on the likely effects on the market will be adopted, the Commission surprisingly states that it considers that "demonstrating the specific effects of [Wanadoo]'s predatory pricing is not decisive for the purposes of

[63] DG Competition discussion paper, *cit.*, para. 131.
[64] DG Competition discussion paper, *cit.*, para. 133.
[65] O'Donoghue and Padilla, *cit.*, chapter 5.
[66] *Brook Group Ltd* v. *Brown and Williamson Tobacco Corp.*, 509 US 209 (1993).
[67] Some authors have advanced that a recoupment analysis seems to be necessary where (i) the predator is not dominant in the market where it makes losses; (ii) a firm with a state monopoly or exclusive right commits predatory pricing by cross-subsidy to a non-dominant market, even where the effects of the abuse only materialize on the non-dominant market; (iii) the price cutting is performed by collectively dominant firms. See O'Donoghue and Padilla, *cit.*, chapter 5.

finding the infringement in question", It contends that "Article 82 EC must be applied where there is a risk of eliminating competition, without having to wait for the object of driving out competition to be achieved"[68].

[68] T-340/03, *France Télécom SA v Commission*, cit., para. 193.

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