UNILATERAL CONDUCT WORKBOOK
CHAPTER 2: ANALYTICAL FRAMEWORK FOR EVALUATING UNILATERAL EXCLUSIONARY CONDUCT

*Prepared by*

***The Unilateral Conduct Working Group***

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1. Unilateral conduct laws differ across jurisdictions, but all prohibit a firm possessing dominance/substantial market power from engaging in exclusionary conduct.[1] This prohibition does not protect consumers by directly addressing the exercise of market power, but rather protects consumers indirectly by addressing conduct that maintains or strengthens the position of dominance/substantial market power.[2] Enforcing this prohibition presents the two fundamental questions addressed by this Chapter: What is dominance/substantial market power? And what makes conduct exclusionary?

2. A jurisdiction's unilateral conduct law, court decisions, and policy statements could have controlling force on how a competition agency answers these two questions, but this Chapter addresses them from first principles. Principles set out here can be of value despite the constraints of statutes, precedents, and guidance documents. This Chapter benefitted from teleconferences with,[3] and from submissions from,[4] ICN members and NGAs on these two fundamental questions.

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1 *See* ICN Report on the Objectives of Unilateral Conduct Laws, Assessment of Dominance/ Substantial Market Power, and State Created Monopolies 2-3 (2007) ("All responding agencies allow for intervention against anticompetitive unilateral conduct, when the firm already has a position of dominance/substantial market power ('SMP')."), *available at* http://international competitionnetwork.org/uploads/library/doc353.pdf. Some competition laws prohibiting abuse of dominance apply both to single-firm dominance and to joint dominance. This Chapter does not consider joint dominance, although many statements would apply to joint dominance if they were modified to refer to a group of firms that potentially hold a jointly dominant position. This Chapter also does not present an analytical framework applicable to unilateral conduct laws' prohibitions on exploiting a position of dominance.

2 In some jurisdictions, unilateral conduct laws also protect consumers by addressing conduct that obtains, or threatens to obtain, a position of dominance/substantial market power.

3 The question what is dominance/substantial market power was addressed in a 7 March 2016 teleconference by: Pablo Ibáñez Colomo, Professor of Law at the London School of Economics; Roger Ware, Professor of Economics at Queen's University in Canada; and Graeme Woodbridge, Chief Economist at the Australian Competition and Consumer Commission. Their written submissions and a transcript of the discussion are available at http://internationalcompetition network.org/uploads/library/doc1084.pdf. The question what makes conduct exclusionary was addressed in a 9 June 2016 teleconference by: Eleanor Fox, Professor of Trade Regulation at New York University; Carl Shapiro, Professor of Business Strategy at the University of California, Berkeley; and Mike Walker, Chief Economic Advisor at the UK's Competition and Markets Authority. Their written submissions and a transcript of the discussion are available at http://internationalcompetitionnetwork.org/uploads/library/doc1083.pdf.

4 Their submissions are available at http://internationalcompetitionnetwork.org/uploads/library/ doc1085.pdf and http://internationalcompetitionnetwork.org/uploads/library/doc1086.pdf.

## I. What Is Dominance/Substantial Market Power?

3. The threshold requirement of dominance/substantial market power in unilateral conduct laws prohibiting exclusionary conduct "serves as a filter for intervention against specific anti-competitive conduct."[5] This Chapter first explores the meaning of dominance/ substantial market power in this context.

4. The Recommended Practices on Dominance/Substantial Market Power Analysis Pursuant to Unilateral Conduct Laws ("Recommended Practices") explain that: "The degree of market power required to constitute dominance/substantial market power and the nature and extent of the evidence required to establish dominance/substantial market power are basic and important policy choices made by legislatures, competition agencies, and courts."[6] This Chapter then examines considerations in making those policy choices.

5. In competition law, just as in economics, "market power is defined generally as the ability to raise price profitably above the competitive level."[7] In competition law, "[d]ominance/ substantial market power is a high degree of market power both with respect to the level to which price can be profitably raised and to the duration that price can be maintained at such a level."[8]

6. Economics and competition law recognize that raising price is not the only way in which a firm can exercise market power. Market power also can be exercised, for example, by reducing quality or service. For the sake of convenience, all such means of exercising market power directly against customers are collectively referred to in this Chapter as "raising price."

7. The degree to which a firm possesses market power is determined by the competitive constraints on its freedom of marketplace action. A firm tightly bound by competitive constraints possesses no market power or insignificant market power. Other firms, with

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5 ICN Report on the Objectives, *supra* note 1, at 39.

6 ICN Dominance/Substantial Market Power Analysis Pursuant to Unilateral Conduct Laws, Recommended Practices 1 (2008), *available at* http://internationalcompetitionnetwork.org/ uploads/library/doc317.pdf.

7 *Id.*

8 *Id.*

more freedom of marketplace action, possess significant, but not substantial market power. Only firms with appreciable freedom from competitive constraints possess dominance/substantial market power.

8. Complete freedom from competitive constraints is not required for a firm to be in a position of dominance/substantial market power, and every real-world firm faces some competitive constraints. Moreover, a firm that was completely free from competitive constraints, both at the present and for the foreseeable future, would not rationally engage in exclusionary conduct. Rational exclusionary conduct is designed to relieve actual or potential competitive constraints.

9. Competition law looks to economics for insight into the determinants of a firm's market power, and dominance/substantial market power is a high degree of market power, but economics does not suggest any particular threshold degree of market power for intervention under unilateral conduct laws. Dominance/substantial market power is a legal concept.

10. Many unilateral conduct laws do not set out criteria for determining whether a firm possesses dominance/substantial market power. Moreover, general usage of the word "dominance" does not suggest any specific criteria for delineating when the degree of market power becomes market "dominance."

11. At most one firm in any relevant market can possess dominance/substantial market power.[9] Customer segmentation could allow multiple firms simultaneously to hold positions of dominance over distinct relevant markets for a single type of good or service. Customer segmentation can arise in many ways, of which this Chapter offers two illustrations: Customer segmentation can stem from heterogeneity in consumer preferences with respect to the product. One firm could possess dominance/substantial market power over the premium products, for example, while another could possess dominance/substantial market power over the budget products. Customer segmentation also can stem from heterogeneity in consumer preferences with respect to the means of obtaining the products and different customers' usage of distinct distribution channels or

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9 As noted in footnote 1, this Chapter does not consider joint dominance, but it is also true that, as a general matter, at most one group of firms can possess joint dominance.

portals. Different firms could possess dominance/substantial market power over particular channels or portals. Such power could be exercised upstream, against product suppliers, as well as downstream, against consumers.

12. Unilateral conduct laws ask whether a firm possesses dominance/substantial market power to filter out instances in which the conduct at issue could not harm (or is unlikely to harm) the competitive process, or in which application of these laws is viewed as inappropriate for other reasons. Although the degree of a firm's market power might be quantifiable in terms of its ability to raise price, a quantitative measure of a firm's ability to raise price is not essential for this filter, and unilateral conduct cases make little use of measures of a firm's ability to raise price.

13. In using dominance/substantial market power as a filter, prohibitions on exclusionary unilateral conduct are concerned not with a firm's ability to raise price but rather with its distinct ability to maintain or strengthen the position of dominance/substantial market power through the adoption of practices that harm the competitive process. These two abilities have somewhat different determinants. For example, the elasticity of market demand (at competitive prices) is an important determinant of a firm's ability to raise prices but not its ability to harm the competitive process. However, certain circumstances give rise to both abilities. For example, a firm will have both abilities when strong consumer demand for its products makes the marketplace viability of a large portion of distributors or retailers depend on carrying them.

14. This Workbook and the Recommended Practices caution that a high market share by itself should not be considered sufficient to establish dominance/substantial market power, for example, because conditions of entry and expansion also are important.[10] A high share, in particular, does not indicate dominance/substantial market power when held for only a short time, especially when market shares are volatile because sales are infrequent and lumpy. A firm is highly unlikely to have the ability to harm the competitive process through the adoption of anticompetitive practices unless it has a persistently high market share. Competition agencies, in any event, use market shares in some way to indicate

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[10] *See* Recommended Practices, *supra* note 5, at 2-3. Of course, a persistently high market share can be achieved through successful competition on the merits.

whether a firm possesses dominance/substantial market power. This is so even though a firm's market share can be a matter of dispute because the scope of the relevant market is disputed.

15. Whatever role a jurisdiction assigns to market share and other factors in the determination of whether a firm possesses dominance/substantial market power, it must set the height of the dominance/substantial market power bar at some level. In doing so, a jurisdiction should consider the implications for enforcement costs and error costs.[11] The relevant enforcement costs in unilateral conduct cases are the public and private resources expended on investigations and litigation. The relevant error costs are the social welfare losses from the suboptimal market performance (for example, higher prices or less innovation) due to imperfect enforcement. Costs from Type 2 errors, or false negatives, arise from the failure to deter or prohibit anticompetitive unilateral conduct. Costs from Type 1 errors, or false positives, arise from prohibiting or deterring procompetitive conduct. Business uncertainty about competition law can chill procompetitive conduct and thus give rise to Type 1 error costs.

16. To reduce enforcement costs and Type 2 error costs, a jurisdiction might adopt a presumption that a firm with a market share above some threshold possesses dominance/substantial market power.[12] A market-share-based presumption, however, achieves significant reductions in enforcement costs only if few firms attempt to rebut the presumption. Such a presumption also risks Type 1 error costs.

17. A low market share is sufficient to assure that unilateral conduct cannot harm the competitive process, or is unlikely to do so. A jurisdiction, therefore, might reduce enforcement costs and Type 1 error costs by adopting a safe harbor for firms with market shares below a certain threshold. Neither cost is likely to be reduced by a market-share-based safe harbor with a very low threshold, however. Firms with very low market shares are unlikely to be concerned about prohibitions applicable only to firms possessing dominance/substantial market power, and competition agencies are unlikely to devote

[11] Enforcement errors and their costs are discussed generally in Chapter 1 of this Workbook at 13-16.

[12] On the use of market-share based presumptions and safe harbors by 35 ICN members responding to a survey, see ICN Report on the Objectives, *supra* note 1, at 47-49.

significant resources to investigating the conduct of firms with very low market shares. However, adopting a market-share-based safe harbor with a very low threshold could cause firms with shares just above the threshold to begin perceiving that they are under scrutiny. On the other hand, a high market-share threshold for the safe harbor risks Type 2 error costs.

18. The reduction in error costs associated with any market-share-based presumption or safe harbor depends on the rate and cost of errors in the conduct assessment that follows a finding that a firm possesses dominance/substantial market power.[13] But even if conduct assessments were error free, a market-share-based presumption or safe harbor could reduce enforcement costs.

19. A competition agency seeking to balance error costs and reduce enforcement costs must consider the interaction of its assessment of dominance/substantial market power with its assessment of competitive effects. For example, a jurisdiction might adopt a market-share-based presumption to concentrate its enforcement resources on its conduct assessment. Similarly, a jurisdiction might adopt a market-share-based safe harbor to concentrate resources on the cases presenting the greatest likelihood of significantly harmful conduct. Either approach could achieve a satisfactory balance of error costs with low enforcement costs.

## II. What Conduct Is Exclusionary?

20. An essential premise of competition law is that a healthy competitive process produces desirable tangible outcomes for consumers. Conduct is "anticompetitive" under competition law when it adversely affects competition, that is, when it harms the competitive process, and is expected, therefore, to harm consumers.

21. Conduct can be anticompetitive even if its adverse impact on the competitive process has not yet occurred. Effects sometimes are assessed under competition law too soon after a

[13] Distinguishing between competition on the merits and exclusionary conduct can be difficult. *See* Workbook ch. 1, ¶ 32; Recommended Practices, *supra* note 5, at ("it can be difficult to distinguish between pro- and anticompetitive unilateral conduct"); ICN Report on the Objectives, *supra* note 1, at 60 ("It is generally difficult to distinguish between competition on the merits and anti-competitive conduct . . . ."). When that is true, some errors are inevitable.

practice is adopted for its effects to be observed; indeed, effects could be assessed after a practice has been adopted but before it is implemented, and, in general, the impact of conduct on the competitive process could take considerable time to appear. Conduct also can be anticompetitive although its impact is uncertain.[14] Actual effects of marketplace conduct can be too subtle and complex for certainty in the assessment, and future effects never can be determined with certainty.

22. The observed impact of conduct on the outcome of the competitive process, for example, price effects, can provide useful evidence as to whether conduct is anticompetitive. Care must be taken, however, in establishing that impacts attributed to the suspect conduct actually were caused by that conduct and that the impacts resulted from an exclusionary effect of the conduct rather than by raising price as a direct exercise of market power. Moreover, a demonstrable adverse impact on market performance is not necessary for conduct to be deemed anticompetitive.

23. Chapter 1 of this Workbook illustrates the fine line that sometimes separates procompetitive and anticompetitive conduct. Competing with low prices that attract rivals' customers is the essence of competition on the merits, even if less efficient competitors fall by the wayside. But predatory pricing—competing with unsustainably low prices that make sense only out of the expectation that they will lead to higher prices after rivals are eliminated—is anticompetitive conduct.[15]

24. Anticompetitive conduct is "exclusionary" under competition law when its anticompetitive effect is achieved by impairing the abilities of actual or potential rivals to compete or by depriving the rivals of opportunities to compete. The adverse effect on rivals necessary for conduct to be exclusionary is termed "foreclosure" or "anticompetitive foreclosure." The concept of foreclosure in competition law is not limited to the effects of forcing market exit and preventing market entry.

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[14] Similarly, conduct can be procompetitive even if no positive impact on the competitive process has yet occurred, and conduct can be procompetitive although its impact is uncertain.

[15] On the competitive assessment of aggressive low pricing, see Workbook, ch. 4; Recommended Practices on Predatory Pricing Analysis Pursuant to Unilateral Conduct Laws (2014), *available at* http://internationalcompetitionnetwork.org/uploads/library/doc966.pdf.

25. Competition law does not exist to insulate firms from competition, but rather to protect the competitive process from efforts to sabotage it. A practice is not considered exclusionary when it causes rivals to falter only because they are inept. In assessing the foreclosure effect of a practice adopted by a firm possessing dominance/substantial market power, a competition agency should determine the responses available to rivals and assess the foreclosure effect of the practice assuming a rational response from rivals.

26. A competition agency should consider whether any suspect conduct is lawful competition on the merits. Actions that advance a firm's interests in no way other than by reducing its costs or better serving its customers are competition on the merits. Some unilateral conduct is inherently competition on the merits, for example, investment in cost-reducing plant and equipment and the introduction of a genuinely new product. Actions that advance a firm's interests only by raising the costs of rivals or hindering their ability to serve their customers plainly are not competition on the merits. Much unilateral conduct is not easily categorized. Chapters in this Workbook on particular practices discuss the assessment of such conduct.

27. A competition agency should draw on economic theory, empirical evidence, and experience in accounting for the likely effects of different practices and the associated error costs. The greater the likelihood that a practice is competition on the merits and apt to benefit customers, the more reticent an agency should be in determining that it is exclusionary in a particular case. Likewise, the greater the likelihood that a practice is exclusionary and significantly harms customers, the more readily an agency should take action against the practice.

28. A specific type of unilateral conduct is inherently anticompetitive if it can have no effect other than to impair the abilities of actual or potential rivals to compete. Demolishing a rival's factory and threatening its customers with violence are inherently anticompetitive, but neither is commonly considered to be within the usual purview of competition law. Commercial conduct that is within the usual purview of competition law also can have no possibility of advancing the commercial interest of the firm engaging in it other than by injuring rivals. An example is a firm paying a supplier or distributor with which it does not do business to cease dealing with its rival.

29. Whether a particular practice of a particular firm is exclusionary typically depends on the circumstances of the market, the firm, and the practice. A competition agency should investigate these circumstances, including any potential justifications for the practice.

30. One issue in a unilateral conduct investigation is whether the suspect practice plausibly has sufficient market impact to be exclusionary, and a useful initial indicator is the "coverage" of the practice—the portion of commerce in the relevant market subjected to the practice by the firm under investigation. A practice rarely has a significant foreclosure effect without having high market coverage. If market coverage is found to be low, an investigation can be terminated unless evidence suggests specific circumstances that nevertheless make a large adverse effect on the competitive process plausible.

31. While a firm's market share can indicate its ability to impose an anticompetitive practice, the coverage of the firm's practice can indicate the practice's potential to produce an anticompetitive effect. In many scenarios, a firm's market share is the limit on the coverage it can achieve with any practice, but coverage sometimes can substantially exceed a firm's market share. Suppose distribution of a particular product is heavily dependent on a small number of Internet portals, and one supplier contracts with each portal on terms that preclude it from promoting any of its rivals' products more than the contracting supplier's products. This practice has a market coverage of approximately 100% even if it is adopted by a firm with market share well below 100%.

32. The likely actual market impact of a practice should be investigated when its market coverage appears to make significant market impact plausible. Even when a firm possessing dominance/substantial market power adopts a practice with large market coverage, the market impact of the practice nevertheless could be slight. For example, tying could have no foreclosure effect when a manufacturer only imposes a tie in sales to distributors or retailers, and final consumers purchasing the manufacturer's tying product can purchase the tied product from a different manufacturer without incurring significant added transaction costs. The tying need not even prevent retailers from stocking the tied product from multiple manufacturers on the same shelf. Similarly, exclusive dealing could have no foreclosure effect if the exclusive deals are only with outlets that rivals gain no advantage from using. A competition agency, therefore, should examine how the

suspect practice likely affects the actual abilities of rivals to compete under the circumstances presented.

33. The intent behind conduct can be evidence of its likely effect, but the intention to succeed in the marketplace at the expense of rivals is found with both procompetitive and anticompetitive conduct. Clear indications of a firm's strategy, and why the strategy makes sense, can demonstrate anticompetitive intent when the firm acknowledges that harm to the competitive process is required for the strategy to succeed or to be profitable. For example, a clearly articulated plan to add temporary money-losing capacity in any local market entered by a rival is strong evidence of anticompetitive intent if the plan makes sense only if it forestalls entry and hence reduces competition. In contrast, a stated desire to "crush the competition" through superior efficiency is procompetitive intent.

34. An intent inquiry should try to distinguish between a strategy to advance a firm's interests by reducing its costs or better serving its customers and a strategy to advance a firm's interests by raising the costs of rivals or hindering their ability to serve their customers. Inquiring into intent is an attempt to determine why an action was taken, and because firms are presumed to act rationally, it is an attempt to determine why the action taken was viewed as profit maximizing. Inquiring into intent, therefore, is apt to require economic analysis and to cover much of the same ground as an inquiry into justifications.

35. Most jurisdictions acknowledge the possibility that conduct found to have an exclusionary effect may be justified, typically on the basis that it promotes efficiency, even if it is not viewed as competition on the merits. When a justification is put forward for such conduct, a competition agency should examine the market circumstances that prompted the action under review. Such a proffered justification could be valid if the action was prompted by circumstances that undermined the firm's ability to serve customers, and it is least likely to be valid when the action under review was prompted by a competitive threat. If the firm's ability to serve customers was somehow compromised, a competition agency should determine whether the action under review actually addressed that problem. Actions are not justified when they are ill suited to address the market circumstances allegedly prompting them. Nor are actions justified when an obvious alternative would have had less adverse impact on rivals.

36. Many jurisdictions consider justifications only after finding an exclusionary effect and place the burden on target firms to raise and prove justifications. In such a jurisdiction, a competition agency nevertheless should have possible justifications in mind from the outset of a unilateral conduct investigation (even if it is not possible to perfectly anticipate the justifications that will be asserted). The evidence needed to evaluate justifications generally also is needed to assess anticompetitive effects, and issues raised by justifications overlap those presented by the assessment of anticompetitive effects.