

PRICE DISCRIMINATION - THE AIRPORTS CASE

Catarina Vieira Peres

Trainee Lawyer

Morais Leitão, Galvão Teles,

Soares da Silva & Associados

SUMMARY: 1. INTRODUCTION. 2. INTRODUCTORY CONCEPTS. 2.1. Definition. 2.2. The different types of price discrimination. 2.2.1. First, second and third Degree price discrimination. 2.2.2. Primary and secondary line injury. 2.3. Incentives for firms to price discriminate. 2.4. Conditions for price discrimination to take place. 2.4.1. Is price discrimination possible in a competitive market? 2.4.2. Limited opportunities for arbitrage. 2.4.3. Information on the reservation price of consumers or of a group of consumers. 3. IS PRICE DISCRIMINATION BAD? 3.1. EU Competition Law Goals. 3.1.1. Economic Welfare. 3.1.1.1. Consumer versus Total welfare. 3.1.2. Effective Competition. 3.1.3. The Single Market Aim. 3.1.4. Fairness and social equity. 3.1.4.1. Redistribution. 3.1.4.2. The protection of small firms. 3.2. Implications of price discrimination. 3.2.1. Efficiency and economic welfare effects. 3.2.1.1. Marginal cost pricing and fixed cost recovery. 3.2.1.2. Ramsey pricing. 3.2.1.3. Welfare effects under first, second and third-degree price Discrimination. 3.2.2. Effects on competition. 3.2.3. Effects of price discrimination on Market Integration. 3.2.4. Fairness. 3.2.4.1. Income distribution. 3.2.4.2. Protection of small firms. 4. ANALYSIS OF ECJ CASES ON DISCRIMINATORY PRICES. 4.1. Belgian, Portuguese and Spanish airports. 4.1.1. Economic analysis. 4.1.1.1.

Why are discounts an abuse? 4.1.1.2. Discrimination on grounds of nationality. 4.1.1.3. Is Article 82 c) the right legal basis when dealing with discrimination on grounds of nationality? 4.2. Final remarks. 5. CONCLUSION.

1 INTRODUCTION.

Price discrimination, what is it? Ask a lawyer and an economist and you might get very different answers. Lawyers will associate discriminatory practices with unfairness, while for economists price discrimination simply refers to the individualization of prices paid by different customers.¹

Price discrimination is a broad concept, for which it is difficult to give a single and exact definition. It is often intertwined with the firms' pricing and marketing strategies. Nonetheless, it is a common practice in business.² It is normal for businesses not to charge the same price to all their costumers: airlines charge different prices for their tickets; in cinemas, students are frequently entitled to discounts; a packet of a dozen donuts is cheaper than donuts bought individually; bars have *happy hours*; the same restaurant might charge a different price for the same meal depending on whether it is served at lunch or at dinner time³. All these are examples of price discrimination.

Not only is discriminatory pricing common, it is becoming increasingly important as a business practice. This is the result of the growth of a digital

¹ PERROI, A., "Towards an effects-based approach of price discrimination", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 161.

² BISHOP, S., "Delivering benefits to consumers or per se illegal?: assessing the competitive effects of loyalty rebates", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 65.

³ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 156.

economy where most commodities are supplied through technologies with huge fixed costs and extremely low marginal costs.

Further, modern information technology has also facilitated the conditions necessary to allow discriminatory pricing schemes to function. As we shall see, the more information an undertaking has about its customers the better it will be able to discriminate amongst them. As modern technology has dramatically reduced the price of acquiring, storing and processing customer information, it has made it easier for undertakings to have more information about their customers.⁴

Amazon.com or Wine.com are good examples of this trend, which allows e-commerce retailers to track the purchasers of each individual buyer and then make special individual offers to each customer based on that information.⁵

Although a common business practice, price discrimination is considered abusive under Article 82 of the EC Treaty when carried out by dominant firms. Price discrimination is described in paragraph (c) of the Article 82 as "applying dissimilar condition to equivalent transactions with other trading partners, thereby placing them at a competitive disadvantage". There are various Commission Decisions and Community Court cases condemning such practices. In fact, both the Commission and the Courts seem to take quite a hostile approach to discriminatory practices when carried out by dominant firms. In various cases, price discrimination is treated as a *per se* prohibition. In other words, the sole fact that the firm offers different conditions to its trading costumers is seen as constituting enough evidence of an abuse of a dominant position, without carrying out an effects analysis, without looking at whether the discriminatory behaviour does in fact harm the competitive process and ultimately whether it is detrimental to consumers.

⁴ GEHRIG, T. and SIENBACKA, R., "Price discrimination, competition and antitrust", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 132.

⁵ PEPALL, L., RICHARDS, D. and NORMAN, G., *Industrial Organisation: Contemporary Theory and Practice*, 3rd ed., Thomson South-Western, Ohio, 2005, p. 114.

Recently, there have been many claims that the "Commission's policy towards price discrimination is at odds with basic economic principles and ignores the business reality".⁶ Indeed, the Commission's approach to Article 82 has been much less based on economic reasoning compared to its policies on vertical restrictions and mergers.⁷ Many argue that the Commission should not sanction discriminatory behaviour adopted by a dominant firm before carrying out a careful microeconomic effects analysis of such conduct.⁸

The problem is that such an effects approach does not please those who like clear and certain rules. Thus, it is sometimes argued that a *per se rule* provides a clear and certain rule for businesses and one should not be very worried about its costs in terms of economic efficiency because under EC law it will only apply to dominant undertakings. In the same sense, some claim that effects analysis of allegedly abusive conduct might contribute to a weakening of antitrust enforcement.⁹ Frequently heard are also fears about the valuable time spent in cases where the effects of conduct have to be analysed, especially if the behaviour under examination is ultimately found to be anti-competitive.

This paper seeks to draw a comparison between the treatment given to price discrimination by economists and by EC competition law and the EC institutions. Having in mind that the Commission and the Community Courts take quite a hostile stance towards price discrimination, we will discuss whether such an approach is justifiable. In order to do so, we will look at the objectives underlying EC Competition law and the potential

⁶ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, pp. 204-205.

⁷ LANG, J., "Anticompetitive Non-Pricing Abuses under European and National Antitrust Law", *International Antitrust Law & Policy*, (2003) 240.

⁸ FERROI, A., "Towards an effects-based approach of price discrimination", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 164.

⁹ BISHOP, S., "Delivering benefits to consumers or per se illegal?: assessing the competitive effects of loyalty rebates", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, pp. 98, 99.

implications that price discrimination might have on the attainment of such objectives.

We will start by looking at the economic definition of price discrimination; the necessary conditions and incentives that lead undertakings to discriminate; the types of discrimination found in practice and the doctrinal classification of price discrimination. This classification will help us to deal with the second part of this paper where we will then look at EC competition law objectives and the economic implication of price discrimination on the achievement of such objectives, in order to see whether a *per se* prohibition on such a practice when taken by dominant undertakings is justified. In the last section, we will take three cases and will subject the reasoning adopted by the ECJ and the Commission to an economic analysis and look at what other motives might have justified the decisions. All these three cases (*Spanish, Belgian and Portuguese airports*) deal with the same problem: discriminatory prices applied by a state-owned firm with a legal monopoly.

2 INTRODUCTORY CONCEPTS.

Definition, conditions, incentives and different types of price discrimination.

2.1 DEFINITION.

Economists usually define price discrimination as the charging of "different price-cost margins on different transactions, typically to reflect different demand conditions".¹⁰ Put more simply, price discrimination describes a situation where the same product is sold to different buyers at different prices, when these differences in price do not exactly reflect differences in

¹⁰ RIDYARD, D., "Exclusionary Pricing and Price Discrimination Abuses Under Article 82 - An Economic Analysis", *European Competition Law Review* 6 (2002) p. 286.

the costs of supply.¹¹ The reverse situation - where the same price is charged to all the costumers, even though the costs of supplying them are considerably different - is, logically, also a form of price discrimination.¹² Therefore an alternative test to price discrimination is sometimes suggested, one which relies on whether "the ratio of prices across markets is different from the ratio of marginal costs".¹³

However, price is not the only way that a firm can discriminate among its customers. As Article 82 states, discrimination is the application of "dissimilar conditions to equivalent transactions"; it therefore does not refer solely to price. An undertaking which controls the supply of a certain input might supply a downstream firm on worse conditions than the ones applicable to its own business active in the same downstream market. If the difference in treatment is not reflected in the cost of the service, one may certainly say that the firm is discriminating between the two. Nonetheless, raising the price of a product of the same quality is, in practice, the same as reducing the quality of a product sold at the same price. Therefore the analysis of non-price discrimination should be very similar to that applied to price discrimination.¹⁴

According to some authors, price discrimination is a vague term used to describe the "strategies used by firms to extract surplus from consumers".¹⁵

One of the reasons why price discrimination is a complex subject is due to the fact that it is present in various kinds of practices. The practices described below are just examples of common business practices:

¹¹ BISHOP, S., "Delivering benefits to consumers or per se illegal?: assessing the competitive effects of loyalty rebates", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 65.

¹² *Assessment of conduct. Draft competition law guideline for consultation*, OFT 414a, 2004, § 3.4.

¹³ CABRAL, L., *Introduction to Industrial Organisation*, MIT Press, London, 2000, p. 168.

¹⁴ *Assessment of conduct. Draft competition law guideline for consultation*, OFT 414a, 2004, § 3.9 and § 3.10.

¹⁵ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 156.

- Loyalty discounts: characteristically, a lower price will be given on condition that the purchaser increases the quantity demanded from the supplier. There are various types of discounts schemes (exclusivity discount, individualised quantity discount, growth discount, bundled discount...). They are designed to produce a "loyalty inducing" effect.¹⁶ These schemes normally involve commitments by the seller to discriminate in favour of purchasers buying big quantities.¹⁷
- Two-part tariffs: according to this pricing system, consumers pay a fixed sum for the service plus a variable amount per unit purchased. The total expenditure of a given consumer can be expressed as follows:

$$T(q) = A + pq$$

Where A refers to the access fee paid independently of the quantity consumed and p refers to the price per unit consumed. It is famously known as "Disneyland Pricing" after a paper by Walter Oi describing the efficient pricing scheme used by amusement parks, consisting in the charging of an entry fee plus a variable price charged per ride. This scheme ensures efficiency and profitability, making it possible to extract a greater surplus from consumers than through linear pricing.¹⁸ Besides amusement parks, two-part tariffs are also commonly used to charge prices for telecoms, electricity, water or gas.

- Versioning: a classical case of price discrimination is to offer customers a set of "packages" of different price and quality

¹⁶ BISHOP, S., "Delivering benefits to consumers or per se illegal?: assessing the competitive effects of loyalty rebates", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 69, 70.

¹⁷ O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 202.

¹⁸ CHURCH, J. and WARE, R. *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 158.

levels. This practice permits the seller to sort out customers according to their willingness to pay. An example of this can be seen in airline tickets. The difference in price between a first class and an economy class ticket does not necessarily reflect differences in cost. Firms frequently reduce the quality of the cheaper lower-quality good so as to convince costumers with a high willingness to pay to buy the high quality good.¹⁹

- Tying and bundling: tying refers to the practice where sellers make the purchase of a product conditional on also buying another. These may be technological ties (for example some ink-jet printers will only work with cartridges of the same brand) and contractual ties (where buyers are bound by a contract to buy all products from the same source). Bundling is sometimes used to refer to tying in fixed proportions (for example: the left and the right shoe are always sold together).²⁰
- Predatory prices: a firm using predatory prices usually discriminates between its existing customers and potential customers of rival undertakings.²¹
- Essential facility cases: when vertically-integrated firms deny their rivals access to essential inputs, once again they are discriminating in favour of their downstream firms.²²
- Price squeeze cases: a discriminatory element is found where vertically-integrated firms favour their own downstream businesses over their rivals.²³

¹⁹ CABRAL, L., *Introduction to Industrial Organisation*, MIT Press, London, 2000, p. 176; CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 159.

²⁰ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 169.

²¹ O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 202.

²² *Ibid.*

²³ *Ibid.*

- Geographic price discrimination: this involves charging higher prices in regions where competition is weaker and lower where competition is stronger.²⁴

2.2 THE DIFFERENT TYPES OF PRICE DISCRIMINATION.

2.2.1 First, second and third degree price discrimination.

Following the work of Pigou,²⁵ it became a common practice among economic theory to make a distinction between first, second and third degree price discrimination.

First degree price discrimination

Sometimes referred as perfect or personalized discrimination, it is used to describe a situation where the firm is able to charge the exact valuation of each consumer for a certain product.²⁶ For this type of discrimination to work it would require the seller to have superhuman powers of intuition to be able to charge to each customer their own reservation price. This

²⁴ SCHERER, F. and ROSS, D., *Industrial Market structure and Economic Performance*, Mifflin Company, Boston, 1990, p. 492.

²⁵ PIGOU, A. C., *The Economics of Welfare*, 1st ed., McMillan, London, 1920.

²⁶ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, pp. 195-196; PEPALL, L., RICHARDS, D. and NORMAN, G., *Industrial Organisation: Contemporary Theory and Practice*, 3rd ed., Thomson South-Western, Ohio, 2005, p. 130. Perfect price discrimination can also be defined as a single take-it-or-leave-it offer to each customer that manages to extract the maximum possible output; VARIAN, H. R., "Price Discrimination", in Schmalensee, Willig (eds.), *Handbook of Industrial Organization*, North-Holland, 1989, p. 598.

technique would enable the seller to extract all the consumer surplus from a heterogeneous group of consumers.²⁷

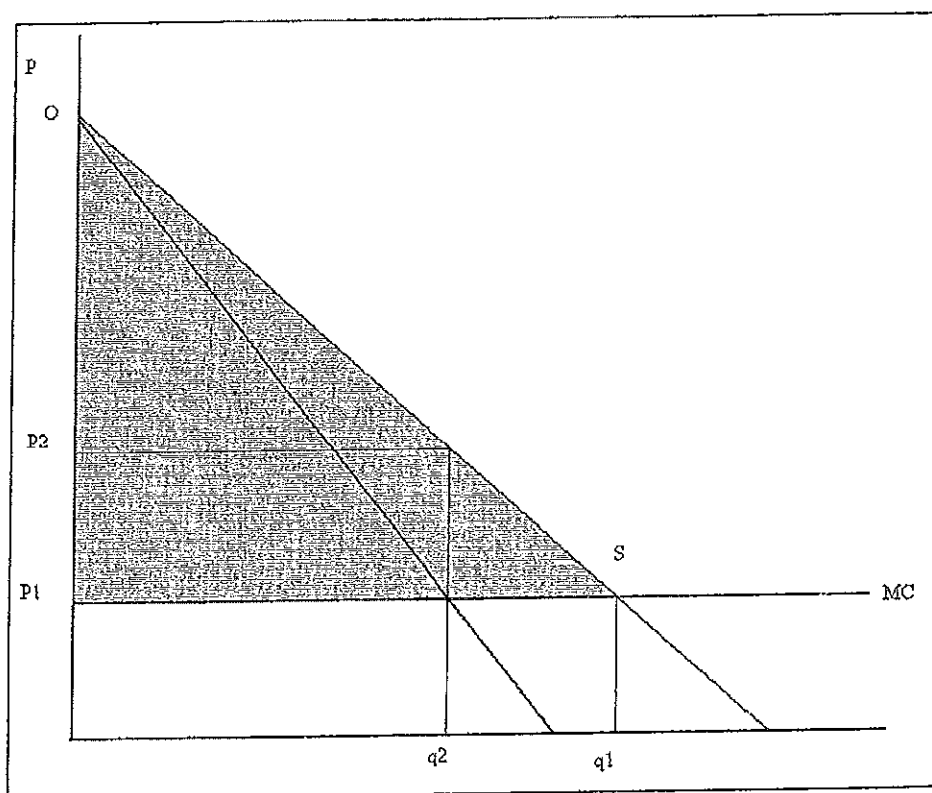


Figure 1: Welfare under first-degree price discrimination.²⁸

It goes without saying that this type of discrimination is extremely rare in practice. A typical example of this type of discrimination is the one of a doctor working for a long time in a very small village; since he will probably know extremely well his patients and their willingness to pay, he will be able to charge each of them their exact valuation for the treatment.

²⁷ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p 162.

²⁸ Welfare corresponds to the triangle OP1S. MOTTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, pp. 18-19, p. 494.

Second-degree price discrimination

Under second-degree price discrimination - also known as block or menu pricing - the seller knows that there are different types of consumers in his market, but unlike the first-degree discrimination, he is unable to identify consumers individually in order to discriminate amongst them.²⁹ Under these conditions, what he can do is to introduce a pricing scheme which will result in consumers revealing what type they are through their purchases. In other words, the usage of this scheme will induce customers to self-select themselves according to their willingness to pay.³⁰

Second-degree price discrimination is commonly used by airlines when the return ticket is cheaper if the passenger chooses to stay in the place of destination over the weekend. The idea behind it is to distinguish tourists from business travellers, since the latter will have more inelastic demand (i.e. they have to be at place X at time Y and will want to return home as soon as possible, hence they will be more willing to pay higher prices) whereas tourists will have a more elastic demand (they will, in principle, be more price sensitive and more flexible in relation to time and place of their holidays and will not mind staying in the place of destination if that means a lower-price return flight). With the use of this system, where passengers select themselves by choosing one of the two options, the airline is able to discriminate and charge higher prices to businessmen and lower ones to tourists.

Second-degree price discrimination can also frequently be seen in vertical relationships where the supplier provides retailers with a menu of

²⁹ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 166; PEPALL, L., RICHARDS, D. and NORMAN, G., *Industrial Organisation: Contemporary Theory and Practice*, 3rd ed., Thomson South-Western, Ohio, 2005, p. 112.

³⁰ BISHOP, "Delivering benefits to consumers or per se illegal?: assessing the competitive effects of loyalty rebates", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 65.

contracts or in relation to final consumers (for example it is commonly seen in mobile phone tariffs).³¹

Third-degree price discrimination.

Unlike the situation with second-degree price discrimination, under third-degree price discrimination the seller is able to use observable characteristic differences between his costumers (e.g. age or location) to directly discriminate amongst them.³² This means that the seller does not need to rely on a "customer self-selecting" mechanism.³³

Furthermore, third-degree price discrimination also differs from perfect discrimination due to the fact that in this case the seller is unable to charge a different price to each individual consumer. Instead, as he knows the market demand curve for the different groups in the market, he will charge a uniform price to all consumers within each group. The discriminatory element exists because the different groups are charged different prices.³⁴

³¹ PERROI, A., "Towards an effects-based approach of price discrimination", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 168.

³² It is important to mention that the distinction between second and third degree price discrimination is not universal. In this paper, we have distinguished the two based on whether the selection is made by the seller through indicators or through a customer self-selecting mechanism. However, some authors define second-degree price discrimination based on the fact that the price changes according to quantity consumed and not based on the identity of the purchaser. Nonetheless, both would define non-linear pricing as second-degree price discrimination. CABRAL, *Introduction to Industrial Organisation*, MIT Press, London, 2000, p. 169-170.

³³ BISHOP, WALKER, *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 195.

³⁴ PEPALL, L, RICHARDS, D. and NORMAN, G., *Industrial Organisation: Contemporary Theory and Practice*, 3rd ed., Thomson South-Western, Ohio, 2005, p. 135; CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 164.

This type of discrimination is very common in practice. Examples include senior discounts, "kids are free" programs, "ladies' night" discos or academic journals that charge different prices to individuals and to institutions (such as university libraries).³⁵

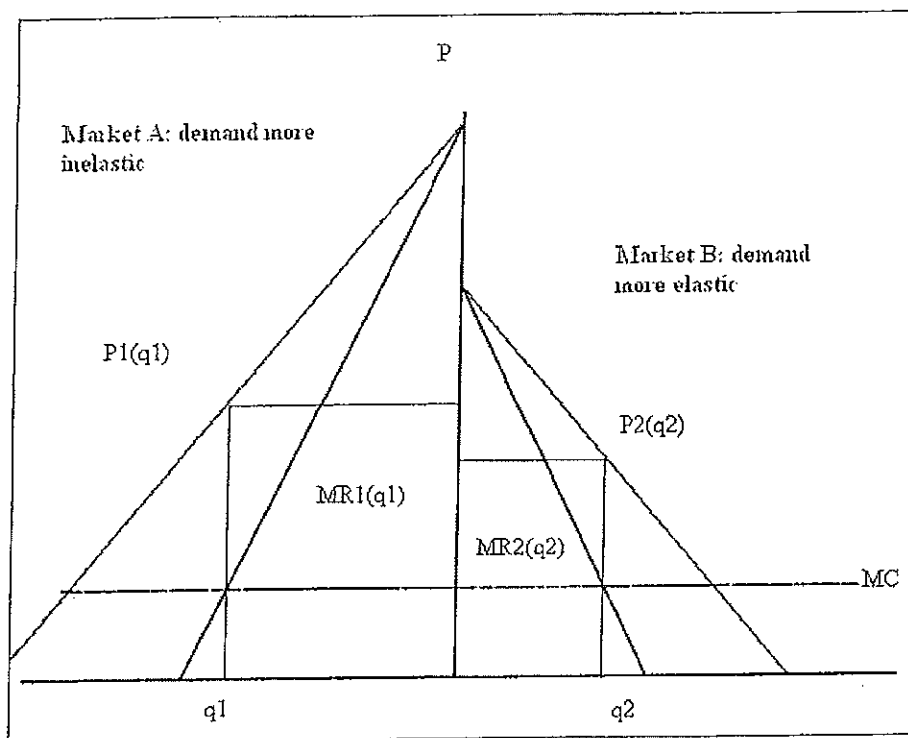


Figure 2: Market Segmentation under third-degree price discrimination.³⁶

³⁵ PEPALL, L., RICHARDS, D. and NORMAN, G., *Industrial Organisation: Contemporary Theory and Practice*, 3rd ed., Thomson South-Western, Ohio, 2005, p. 136.

³⁶ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 165.

2.2.2 Primary and secondary line injury.

Some authors also distinguish between discrimination against the competitors of the seller (normally referred to as primary-line injury) and discrimination among customers with whom the seller does not compete (secondary-line injury). In the latter case the potential harmful effects of price discrimination take place in a market where the discriminatory seller is not active.

An example of a primary-line injury would be the case where a seller selectively cuts the prices to those purchasers that might switch to one of his competitors, while maintaining prices high to the other buyers.³⁷ Whereas a case where a vertically-integrated firm, controlling an essential input, decides to charge a lower price to its downstream subsidiaries than to the rest of its costumers would be an example of a secondary-line injury.³⁸

The incentives, the ability and the effects of price discrimination in the above two cases are considerably different, and therefore different economic and legal principles should apply.³⁹

2.3 INCENTIVES FOR FIRMS TO ENGAGE IN PRICE DISCRIMINATION.

The reasons behind price discriminatory behaviour may be various, and include the following: to recover fixed-costs, to prevent new firms from entering the market or to exclude rivals. Incentives to price discriminate depend on a serious of factors such as the position of the firm in the market, i.e. on whether the firm is vertically or non-vertically integrated. However, the basic economic reason why firms engage in discriminatory

³⁷ An example of primary-line injury is often found in telecommunications where consumers are offered better deals when they are about to switch operators.

³⁸ GERARDIN, G. and PEIHL, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series*, 2005, pp. 15-29.

³⁹ O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 553.

prices has to do with the existence of an unexploited surplus in the market. Price discrimination refers exactly to the techniques that firms will want to adopt to extract an unexploited consumer surplus existing in the market and increase their profits.⁴⁰

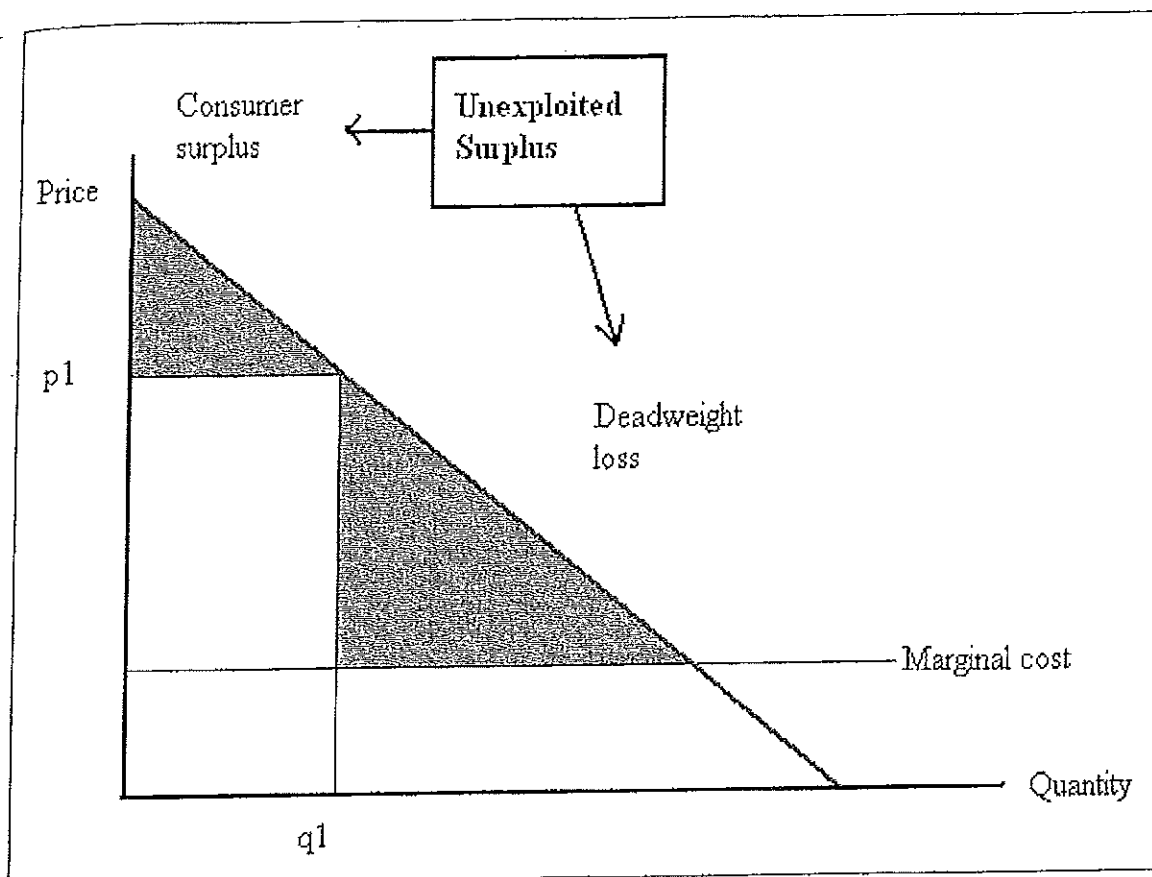


Figure 3: Motive for Price Discrimination: unexploited surplus.⁴¹

⁴⁰ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 157.

⁴¹ *Ibidem*.

2.4 CONDITIONS FOR PRICE DISCRIMINATION TO TAKE PLACE.

Firms are not always able to price discriminate; in order to do so, some conditions must be present. We shall now analyse what they are.

2.4.1 Is Price discrimination possible in a competitive market?

There is some discussion about how much market power a firm needs in order to profitably price discriminate. One can frequently find statements declaring that price discrimination cannot occur if the market is competitive.⁴² This, however, is not entirely true. It is true that price discrimination is not possible in the theoretical model of a perfect competitive market, where firms have to take the price as a given, consumers are free to choose amongst alternatives and where the price of all units of all goods will be equal to the level of costs.⁴³ This means that in order to price discriminate the firm must possess some degree of market power. But price discrimination does not occur solely with monopolies; in real world competitive markets - where goods are not always homogeneous and consumers have different preferences - price discrimination is possible. To price discriminate it is enough for the firm to have power over its own prices, in other words, it is sufficient for a firm to face a negatively sloped demand curve for its product.⁴⁴

⁴² An example of such statement may be found in the UK OFT *Assessment of Individual Agreements and Conduct*, § 3.6, where, it is affirmed that "price discrimination is not sustainable in a competitive market". OFT 414 (1999).

⁴³ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 160; BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 195.

⁴⁴ VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p 255.

2.4.2 Limited opportunities for arbitrage.

For price discrimination to work, consumers who are being charged higher prices must be unable to buy the product from consumers who are being charged lower prices. For example, if a producer sells widgets to group A for 10€/unit and to group B for 5€/unit, he will lose all his sales to group A, if consumers in this group manage to buy widgets from group B for less than 10€.

Resale is virtually impossible in the case of services or when the products cannot be stored (an example is electricity).⁴⁵ Resale will also not occur when the transaction costs are higher than the price differential (i.e. the difference in price between the one at which the good was bought and the price at which it was to be sold), as this would make profits of arbitrage negative. Resale opportunities might also be limited due to geographical distances - where buying the product in one place and selling it in another is an unprofitable activity given the high transportation costs or the import tariffs.⁴⁶ Arbitrage might be impossible due to asymmetric information, as consumers in one market might know nothing about the conditions in another market. There can also be legal barriers preventing the resale of a product.

When arbitrage is "naturally" possible, the seller might also make resale impossible or highly difficult through the use of instruments such as warranties (i.e. not offering warranties in countries where he does not want his product to be sold); adulteration (imagine the case where a producer sells a material that can be both used to make dental utensils or for industrial construction. The producer will only be able to charge a higher price for the material to the dental instrument manufacturers if he can stop them from buying it from builders, and one way of doing so is to add a poisonous substance to the material sold to builders, thus preventing them from reselling it to the dental manufacturers); contractual remedies (where the buyer has to agree not to resell the product) or through vertical

⁴⁵ O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 558.

⁴⁶ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 160.

integration (for example, where a producer makes a substance that can be used to make two types of goods - X and Y, the producer might want to charge a low price to X producers and a high price to Y producers, but that will not be possible if the Y producer is able to buy the product from the X producer, the substance producer might thus vertically integrate with X in order to prevent it from reselling the substance to Y).⁴⁷

2.4.3 Information on the reservation price of consumers or of a group of consumers.⁴⁸

In order to price discriminate the firm must be able to separate its consumers or group of consumers. The firm must not only know its own market demand curve "but also how that demand curve has been constructed from the individual consumer demand curves"⁴⁹. This amounts to saying that it has to have information on how the consumers differ in their demand for the product. When the seller does not have this kind of information he might still try to gather it through the introduction of pricing schemes so that customers self-select themselves according to their own reservation prices (this is what happens under second-degree price discrimination).⁵⁰

⁴⁷ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, pp. 160-161; CARLTON, D. W., PERLOFF, J. M., *Modern Industrial Organisation*, Longman Higher Education, 1990, pp. 278-280.

⁴⁸ VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p. 263.

⁴⁹ PEPALL, L., RICHARDS, D. and NORMAN, G., *Industrial Organisation: Contemporary Theory and Practice*, 3rd ed., Thomson South-Western, Ohio, 2005, p. 120-121.

⁵⁰ PEPALL, L., RICHARDS, D. and NORMAN, G., *Industrial Organisation: Contemporary Theory and Practice*, 3rd ed., Thomson South-Western, Ohio, 2005, p. 121.

3 IS PRICE DISCRIMINATION BAD?

The Objectives of Article 82 of the Treaty and the Implications of Price Discrimination.

3.1 EU COMPETITION LAW GOALS.

EC Competition Policy does not apply in a vacuum; the Commission has often stated that competition policy has to be applied with reference to the priorities fixed by the Community.⁵¹ Behind EC competition rules lie various different goals. These goals, some more economics-based, others more political in nature, are not always compatible and may imply complicated trade-offs.⁵²

In 2005, the Commissioner Neelie Kroes, stated that

“the objective of Article 82 is the protection of competition on the market as a means of enhancing consumer welfare and ensuring an efficient allocation of resources”⁵³

The development of this idea can be found on the DG Comp’s Discussion Paper on the application of Article 82 to exclusionary abuses:

“With regard to exclusionary abuses the objective of Article 82 is the protection of competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources. Effective competition brings benefits to consumers, such as low prices, high quality products, a wide

⁵¹ *XXVIIIth Report on Competition Policy*, DG Competition (1997); AHLBORN, C., AND PADILLA, A. J., “From Fairness to Welfare: Implications for the Assessment of Unilateral Conduct Under EC Competition Law”, in Marquis, M., and Ehlermann, C.D., *European Competition Law Annual*, Hart Publishing, Oxford, 2007, p. 2-8.

⁵² VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p. 17.

⁵³ *Preliminary thoughts on Policy Review of Article 82*, Speech at the Fordham Corporate Law Institute, New York 2005, available at

<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/537&format=HTML&aged=0&language=EN&guiLanguage=en>

selection of goods and services, and innovation. Competition and market integration serve these ends since the creation and preservation of an open single market promotes an efficient allocation of resources throughout the Community for the benefit of consumers."⁵⁴

From these statements we can infer that behind the competition rules lie goals such as the attainment of welfare and efficiency, ensuring a system of effective competition and market integration. We shall now analyse these and the effects of price discrimination on their attainment.

3.1.1 Economic Welfare.

Welfare is an economic concept which measures how well the industry is performing. Total welfare (or surplus) includes the welfare of various groups in the economy, being equal to the sum of consumer and producer surplus. The surplus of an individual consumer is the difference between what he is willing to pay (i.e. his valuation of the good) and the price eventually paid. Consumer welfare refers to the sum of the surplus of all consumers in a given market. On the other hand, the surplus of an individual producer refers to the profit made by selling the product. Hence, producer welfare is the sum of all profits of all producers in an industry.⁵⁵

It is important to bear in mind that welfare and income distribution between consumers and producers are two different issues. Welfare is a measure used to describe how efficient a given industry is as a whole; it does not address the question of how equally income is distributed.⁵⁶

⁵⁴ § 14. available at <http://ec.europa.eu/comm/competition/antitrust/art82/discpaper2005.pdf>.

⁵⁵ MOTTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, pp. 18-19.

⁵⁶ *Ibid.*

3.1.1.1 Consumer versus Total welfare.

A long debate exists as to whether competition law should protect consumer or total welfare.⁵⁷ In the majority of cases the question is not of great relevance because practices that decrease total welfare usually also lead to a decrease in consumer welfare and vice-versa. However, it is of particular importance in our case because price discrimination is one of those particular cases where total and consumer welfare might not move in the same direction.⁵⁸ As we shall see, perfect price discrimination will lead to the increase of total welfare but to the disappearance of consumer welfare. Therefore the decision on whether or not to ban price discrimination will depend to a certain extent on the welfare standard applied.⁵⁹

Economists tend to prefer the total welfare to the consumer standard. This means that they will treat a gain of 1€ made by consumers or by producers as being of equal value.⁶⁰ They view welfare transfers from consumers to producers as neutral, unlike the situation under the consumer welfare model where such transfers are seen as harmful.⁶¹ Many argue that it would be unwise for competition authorities to adopt a consumer welfare standard since this does not take into account the gains made by the firms. The problem is that in today's economies many consumers own funds, which means that dividends will be distributed amongst consumers who

⁵⁷ AHLBORN, C., AND PADILLA, A. J., AHLBORN, C., AND PADILLA, A. J., "From Fairness to Welfare: Implications for the Assessment of Unilateral Conduct Under EC Competition Law", in Marquis, M., and Ehlermann, C.D., *European Competition Law Annual*, Hart Publishing, Oxford, 2007, p. 5.

⁵⁸ MOTIA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 19.

⁵⁹ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 196.

⁶⁰ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 24.

⁶¹ VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p. 64-65.

would end up in a worst position if firms' profits were reduced. Some go as far as to say that if the argument of consumer surplus was taken literally, it would imply that prices would all have to be equal to marginal costs and, in the long-run, this would cause all firms to leave the industry or they would have to be subsidised in order to cover fixed costs.⁶² Lower profits also mean that the incentives for firms to innovate would be considerably lower.

However, EU competition law, unlike economists, values consumer welfare above producer welfare.⁶³ As we saw, both in Neelie Kroes's speech and in the DG Comp's discussion paper the reference is made to "consumer welfare" and not to total welfare. This means that EC competition law is mainly concerned with the reduction in consumer surplus and not with the deadweight social welfare cost of a monopoly.⁶⁴

The problem with the consumer model if not well understood is that it will lead regulators to treat the pursuit of such objective in an entirely static framework, and hence to sub-optimal results – such as the lack of investments. Therefore, if the total welfare standard is not adopted, one should at least consider the objective as that of maximising consumer welfare in the long-run "otherwise by helping consumers today one might hurt consumers tomorrow".⁶⁵

⁶² MOTIA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 21.

⁶³ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 24.

⁶⁴ *Ibid.* In the US, courts and antitrust authorities have also adopted a consumer welfare model, whereas in Canada, New Zealand and Australia, competition authorities favour the total welfare standard. MOTIA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 20-22.

⁶⁵ MOTIA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 21.

3.1.2 Effective Competition

Effective competition is the core principle underlying EC competition law.⁶⁶ In fact, in *Continental Can*,⁶⁷ the ECJ has even affirmed that the maintenance of effective competition is so crucial that "without it numerous provisions of the Treaty would be pointless".⁶⁸ The concept of "effective competition" does not correspond to any theoretical model of competition (such as perfect, contestable or workable competition) but it implies the idea that firms should be subjected to a certain degree of constraints from their competitors or from customers. The role of antitrust authorities should be to ensure that such constraints exist in the market.⁶⁹

3.1.3 The Single Market Aim.

EC Competition policy has to be understood within the framework of the Community's *raison d'être* – the creation of a single market,⁷⁰ where internal barriers are eliminated and goods, services, workers and capital are able to circulate freely. The "Single Market Aim" is a political objective and it is sometimes described as an "obsession" of the EC authorities. This factor sometimes might explain why behaviour considered abusive under EC law would not necessarily be classified as such under a jurisdiction not concerned with "market integration".⁷¹

⁶⁶ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 12.

⁶⁷ Judgement of the European Court of Justice of 21 February 1973, C-6/72, *Europemballage and Continental Can v. Commission*, ECR [1973] 215.

⁶⁸ BELLAMY & CHILD, *European Community Law of Competition*, Sweet & Maxwell, London, 2001, pp. 39-40.

⁶⁹ WHISH, R., *Competition Law*, 5th ed., Oxford University Press, 2005, pp. 15-16.

⁷⁰ AHLBORN, C., AND PADILLA, A. J., AHLBORN, C., AND PADILLA, A. J., "From Fairness to Welfare: Implications for the Assessment of Unilateral Conduct Under EC Competition Law", in Marquis, M., and Ehlermann, C.D., *European Competition Law Annual*, Hart Publishing, Oxford, 2007, p. 5.

⁷¹ WHISH, R., *Competition Law*, 5th ed., Oxford University Press, 2005, pp. 20-21.

However, some authors argue that while efficiency and welfare are appropriate goals for competition policy to pursue, the same does not hold true for the "Single Market Aim".⁷² "It is highly questionable whether competition law is an appropriate instrument to further market integration".⁷³ This is a political objective that should be pursued, but by using other legal instruments. The problem lies in the fact that this goal and the goal of economic welfare may conflict.⁷⁴

3.1.4 Fairness and social equity.

3.1.4.1 Redistribution.

Although it is not mentioned in the statements quoted above, competition law is sometimes attributed the role of income redistribution. Aggregations of wealth in the hands of monopolists might be seen as a threat to democracy, economic opportunity and individual freedom.⁷⁵

However, governments have other means of achieving equality (e.g. through the tax system) other than competition policy. Further, this is a political issue and not an economic one. It is not concerned with allocative efficiency which should nevertheless be pursued for the sake of economic and social development.

3.1.4.2 The protection of small firms.

Some argue that competition law should be applied in a way that protects small and medium firms.⁷⁶ Indeed in many ECJ cases, the Court seems to

⁷² VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p. 47.

⁷³ *Ibidem*.

⁷⁴ MOTTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 23.

⁷⁵ WHISH, R., *Competition Law*, 5th ed., Oxford University Press, 2005, p. 18.

⁷⁶ Indeed the Commission seems to believe that small and medium enterprises are more likely to innovate than large ones and give a greater contribution to economic

be protecting competitors from dominant undertakings. For example, in *United Brands* the Court affirmed,

*"[...] such a course of conduct [by the dominant undertaking] amounts therefore to a serious interference with the independence of small and medium sized firms in their commercial relations with the undertaking in the dominant position".*⁷⁷

The protection of smaller competitors is frequently justified by reference to a concept of fairness, in the sense that there should be "equal opportunities for everyone". The roots of this goal are therefore found in political theory.⁷⁸

The problem is that protecting competitors is not a goal directly linked to the allocative efficiency aim. In fact it can run counter to the idea of economic welfare, when it leads to the protection of inefficient firms and to the hindering of the performance of large and efficient undertakings.⁷⁹ Artificial protection of inefficient small firms will result in higher prices and an inefficient allocation of resources.⁸⁰

growth and employment. Empirical evidence, however, does not confirm it. MOTTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 22.

⁷⁷ Judgement of the European Court of Justice of 14 February 1978, C-27/76, *United Brands v. Commission* ECR [1978] p. 00207, § 193.

⁷⁸ VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p. 50. It is interesting to note that in the USA discriminatory prices are forbidden by section 2 of the Clayton Act (normally referred as the Robinson-Patman Act). Such prohibition was introduced in 1936, during a period of economic depression to protect small retailers who were being expelled from the market, due to the power of certain large retail firms who received great discounts from suppliers and therefore placed the small retailers at a competitive disadvantage. FRAZER, T., *Monopoly, Competition and the Law: The Regulation of Business Activity in Britain, Europe and America*, Wheatsheaf books, New York, 1988, p. 277.

⁷⁹ WHISH, R., *Competition Law*, 5th ed., Oxford University Press, 2005, p. 19.

⁸⁰ MOTTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 22.

3.2 IMPLICATIONS OF PRICE DISCRIMINATION.

3.2.1 Efficiency and economic welfare effects.

Price discrimination is a complex phenomenon, and it therefore comes as no surprise that its impact on welfare is not self-evident and that it cannot be defined *a priori*. In fact, this question is quite ambiguous and will depend on the type of price discrimination being exercised.⁸¹ Hence the need for a case-by-case analysis.⁸²

3.2.1.1 Marginal cost pricing and fixed cost recovery.

Marginal cost⁸³ pricing is the central pillar of welfare economics. Ideally, all prices should be equal to marginal costs. If the price of goods is below marginal cost it will lead to over consumption, as consumers will buy the good even though their valuation is less than the cost of supplying it. If the price is above marginal cost it will lead to under-consumption, as some consumers will not buy the good even though their personal valuation was above the cost of supplying it. The classical textbook example of a monopoly abuse has the monopolist not charging prices that equal marginal costs but prices that are above it. The result is a decrease in output and in consumption and an increase in the monopolist's profits.⁸⁴ Under price discrimination, prices will not be equal to marginal costs.⁸⁵

⁸¹ SCHERER, F. and ROSS, D., *Industrial Market structure and Economic Performance*, Mifflin Company, Boston 1990, p. 494; O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 558.

⁸² GERARDIN, G. and PEILL, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series* (2005), pp. 15-29.

⁸³ Marginal cost is defined as the cost of producing the last unit of production.

⁸⁴ RYDIARD, D., "Exclusionary Pricing and Price Discrimination Abuses under Article 82 - An Economic analysis", *European Competition Law Review*, 6 (2002) p. 286.

⁸⁵ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 197.

However, "marginal cost" is a laboratory designed concept for use in textbooks, rather than guidance for business decisions or competition law.

The biggest practical problem when applying marginal cost pricing is how to recover fixed costs. This is due to the fact that many industries face low marginal costs but very high fixed costs.⁸⁶ If firms charged all consumers a very low price (close to marginal cost, and therefore below average cost) they would be unable to recover their fixed costs. "In fact there is virtually no industry that makes worthwhile investment and that does not exhibit some characteristics of fixed-cost recovery".⁸⁷ Firms are therefore likely to charge prices above marginal costs. This brings us to the fact that in the real world, price differences cannot be fully justified by differences in production costs.

Furthermore, uniform pricing schemes might not enable the firms to recover fixed costs. In such instances, if price discrimination were to be banned, producers would very likely stop producing the product. Therefore, even though such a scheme will mean that prices will be above marginal cost - which implies a loss of static efficiency⁸⁸ - this must be

⁸⁶ Examples of such industries include pharmaceuticals, software, telecoms, information-based industries and old industries. BISHOP, S., "Delivering benefits to consumers or per se illegal?: assessing the competitive effects of loyalty rebates", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 66. For a discussion on how price discrimination might enhance social efficiency on network infrastructure industries, such as energy, telecoms and transports, see PROSPERETTI, L., BERETTA, M., SIRAGUSA, M., MERINI, M., *Economia e diritto antitrust, Un'introduzione*, Carocci editore, Rome, 2006, p. 238.

⁸⁷ RYDIARD, D., "Exclusionary Pricing and Price Discrimination Abuses under Article 82 - An Economic analysis", *European Competition Law Review*, 6 (2002) p. 287.

⁸⁸ This means that some consumers, even though they value the product above its marginal cost, will not buy it.

traded-off with the risk that the product would not even be produced if investors did not have the prospect of being able to recover fixed-costs.⁸⁹

3.2.1.2 Ramsey pricing.

The problem of fixed cost-recovery brings us to this issue of Ramsey Pricing. Frank Ramsey⁹⁰ developed the idea that when there are fixed costs to be recovered and tax revenue to be raised the most efficient price structure is one where the mark-up above marginal-cost for each good is inversely related to the customers' sensitivities for the respective good. For example: a firm produces good X and good Z. It incurs joint-fixed costs for producing both goods. The demand for good X is very elastic, whereas the demand for good Z is more inelastic. In order to minimise the distortion in economic behaviour resulting from too high-pricing, the firm should set the price for product Z at a level that recovers proportionately more shared costs than the price set for X.⁹¹

When Ramsey's theory is applied to price discrimination, it means that when they are joint-fixed costs, price discrimination will lead to an improvement in economic welfare.⁹²

⁸⁹ RYDIARD, D., "Exclusionary Pricing and Price Discrimination Abuses under Article 82 - An Economic analysis", *European Competition Law Review*, 6 (2002) p. 287.

⁹⁰ Frank Ramsey was an economist and mathematician from the beginning of the 20th century. His theory was designed when searching for optimal taxation structures.

⁹¹ *What price is right? Lessons from the UK Call-to-Mobile Inquiry*. Competition memo, Lexecon, London, 1999. Available at <http://www.crai.com/ecp/publications/archive.htm>.

⁹² Ramsey pricing, as a principle, has been accepted by some competition authorities. However the use of this principle can be extremely difficult in practice because demand patterns are considerably more difficult to measure than costs. See *What price is right? Lessons from the UK Call-to-Mobile Inquiry* Competition memo, Lexecon, London, 1999.

3.2.1.3 Welfare effects under first, second and third-degree price discrimination.

When describing first-degree price discrimination, it is commonly said that a perfect discriminatory monopolist will be able to extract the full consumer surplus since he is charging every customer his own reservation price. As welfare is the sum of producer profits and consumer surplus, first-degree price discrimination will lead to the highest possible economic welfare.⁹³ Furthermore, the reservation price of the marginal consumer (i.e. the consumer with the lowest marginal reservation price that buys the product) will be equal to the marginal cost. Therefore the first-degree discriminatory monopolist produces the right amount of output, whereas a monopolist charging a uniform price will not produce sufficient output and thus will create a deadweight loss. Some authors⁹⁴ also refer to the fact that because the firm is extracting all of the surplus, the decision on which products to produce will follow the right guidelines from an economic efficiency perspective. In other words, in order for a monopolist to capture the complete economic surplus he will need to align his objectives with those of society, which means that his decisions - on the amount of output product quality and choice - will be socially efficient.

However, under first degree price discrimination, unlike in a perfect competition situation, there is no consumer welfare, i.e. consumer surplus is zero. This is why when designing a policy to tackle the issue of price discrimination, the choice on the standard of welfare becomes so relevant.⁹⁵

Perfect discrimination is, as we have seen, highly uncommon. Therefore, greater emphasis should be given to second and third-degree price

⁹³ MOTTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 493.

⁹⁴ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 163.

⁹⁵ To put it in simple terms, where an economic welfare standard as been adopted price discrimination should not pose as many problems as in the case where the standard is one of consumer welfare. BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 196.

discrimination whose effects, independently of the welfare standards used, are much more ambiguous.⁹⁶ The basic intuition behind third-degree price discrimination is that a firm selling in two markets with different elasticities of demand (for example: the demand in market A is more inelastic while that in market B is more elastic), in order to maximise its profits will charge a higher price in market A and a lower price in market B. If we compare the differences in welfare of a change from uniform to discriminatory prices we come up with the following conclusions: the seller increased his profits (as he could have supplied both markets at a uniform price, the fact that he did not implies that his profits have increased by charging different prices); consumers in market A will be worst off, since they will be charged a higher price than under an uniform price; consumers in market B will be better off, since they will be charged a lower price.⁹⁷ But this does not tell us much about the welfare effects, it just shows that the losses in one group have been traded-off by the gains in another. Welfare effects under third-degree price discrimination are indeterminate, but they will increase welfare if it leads to an increase in output.⁹⁸ Price discrimination will clearly be welfare enhancing in cases where, if the firm is forced to charge uniform prices, it will stop supplying one group of consumers. For example a film producer sells movies in Japan and in India and he charges a much higher price in Japan than in India. If he were forced to sell the movies at the same price in both countries he might then prefer to abandon the Indian market altogether. This would happen if the price at which it would have to charge in India would result in reduced

⁹⁶ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 197.

⁹⁷ CHURCH, J. and WARE, R., *Industrial Organization, A Strategic Approach*, McGraw Hill, Ontario, 2000, p. 165; TIROLE, J., *The Theory of Industrial Organization*, 9th ed., The MIT Press, Massachusetts, 1997, p. 137. For a detailed analysis on how the presence of international price discrimination is the result of considerable different price elasticities of demand across the European car market see VERBOVEN, F., "Price discrimination in a common market, International price discrimination in the European car market", in Philips (ed.), *Applied Industrial Economics*, Cambridge University Press, Cambridge, 1998, p. 196.

⁹⁸ VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p. 18.

profits from the Japanese market due to the fact that the high willingness to pay from this group clearly outweighs the profits from India.

As we have seen, unlike perfect discrimination, where consumers are charged their exact valuation for the product, under third-degree discrimination the seller tries to segment the market in various groups; this involves an economic inefficiency as probably there will be customers in the higher-priced group that will not buy the product at such a high price but actually value it more than some people in the lower priced group who end up acquiring the good. This situation is economically inefficient, as economic efficiency requires that the good should be bought by those who value it the most.⁹⁹ To put it another way, "static welfare could be improved if that marginal unit was redistributed from the low-priced to the high priced market".¹⁰⁰ However, this inefficiency is out-weighed if the alternative – uniform prices – leads to a lower amount of output.¹⁰¹

Second-degree discrimination raises essentially the same issues as third-degree price discrimination. Once again, welfare effects will depend on whether or not output is increased. For example, rebates producing exclusionary effects may force sellers to exit the market leaving alone the dominant firm and this will result in a reduction of output; on the other hand, a ban on volume discounts would very probably lead to lower output, when a uniform price means that some consumers will not be served any longer.¹⁰²

This brief and summary analysis demonstrates that according to economic theory a *per se* prohibition on price discrimination is not justifiable, as on a

⁹⁹ BISHOP, S and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 197.

¹⁰⁰ RYDIARD, D., "Exclusionary Pricing and Price Discrimination Abuses under Article 82 – An Economic analysis", *European Competition Law Review*, 6 (2002) p. 286.

¹⁰¹ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 197.

¹⁰² *Ibidem*, p. 198; GERARDIN, G. and PEHII, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series* (2005), p. 6.

number of occasions price discrimination may not be detrimental to welfare.¹⁰³ However, some authors¹⁰⁴ argue that these economic models do not provide an operational guide as to when competition authorities should intervene. The reason being that these models relate to a price-discriminating monopolist, where the output of the firm is equal to the amount of output on the industry as a whole. These models compare whether welfare would be increased under price discrimination as opposed to a uniform-price situation charged by a monopolist, whereas competition law discussions should refer to competitive situations and should assess a given behaviour in relation to its impact on dynamic competition. We do not entirely share this view. Article 82 cases are always analysed based on the fact that the firm enjoys a "dominant position", which means a position of economic strength that allows it to behave to a great degree independently of its competitors, its customers and, ultimately, in relation to consumers.¹⁰⁵ It is true that a dominant position does not necessarily mean that the firm has a monopoly but, as we have discussed, in order to price discriminate it is sufficient for the firm to enjoy some degree of market power. Therefore, we consider that the information given by these economic models, even if they refer to monopoly markets, can be highly useful when discussing the action that competition authorities should adopt.

¹⁰³ GERARDIN, G. and PEHII, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series* (2005), p. 7.

¹⁰⁴ RYDIARD, D., "Exclusionary Pricing and Price Discrimination Abuses under Article 82 - An Economic analysis", *European Competition Law Review*, 6 (2002) p. 288.

¹⁰⁵ Judgement of the European Court of Justice of 13 February 1976, C-85/76, *Hoffman-La Roche v. Commission*, ECR [1979] p. 461, at § 38. Furthermore, the Court has repeatedly stated that the fact that the undertaking enjoys a "dominant position does in itself imply any criticism". Judgement of the Court of First Instance of 8 October 1996, joined cases T-24/93, T-25/93, T-26/93 and T-28/93 *Compagnie Maritime Belge Transports SA and Others v. Commission*, ECR [1996] p. II-1211 at § 60.

3.2.2 Effects on competition.

We will now look at the question of whether price discrimination can be used in an anti-competitive way - as a monopolisation device to change market structure.¹⁰⁶ This section will therefore consider whether price discrimination might prevent entry, force exit or allow a dominant undertaking to increase its power.

One way in which price discrimination might be detrimental to the competitive process is by raising barriers to market entry. Take, for example, the case where producer A enjoys a monopoly in market segments X and Y, where he sells widgets at 10€ each. A new entrant (B) tries to enter market X, offering widgets at 8€. If A was not allowed to engage in price discrimination, he would have to lower his price to 7€ in both markets in order to try to discourage B from entering market X. Whereas, if it were legal to price discriminate, A could charge low prices in market X, while keeping prices high in market Y. Price discrimination, therefore, decreases the costs of harming a new entrant.¹⁰⁷ The same applies to a dominant undertaking who wants to price discriminate, or more precisely to use selective price cuts in order to meet smaller firms' efforts to expand or to introduce new products.

In relation to the above, it is often argued that a "dominant undertaking may use a discriminatory pricing structure to set predatory prices".¹⁰⁸ However these cases do not necessarily need to involve predatory prices, i.e. they do not necessarily involve pricing below average costs, for the dominant firm may not need to eliminate competitors altogether.¹⁰⁹ In actual cases, it might be difficult to distinguish where the firm was merely

¹⁰⁶ MOTTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 498.

¹⁰⁷ SPECTOR, D., "The Strategic Uses of Price Discrimination", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 190.

¹⁰⁸ *Assessment of conduct. Draft competition law guideline for consultation*, OFT 414a, 2004, § 3.4.

¹⁰⁹ SHEPHARD, D., "The Dominant Firm in Relation to Market Structure", in Jacquemin, Jong (eds.), *Welfare aspects of industrial markets*, Martinus Nijhoff, Leiden, 1977, p. 27.

trying to meet competition and where it was engaging in "more predatory kill-the-rival types of price discrimination",¹¹⁰ Furthermore, unsuccessful predatory discrimination can positively result in no more than a period of intensified competition.

It might be risky to prevent a monopolist from price discriminating between markets. A rule of this nature might provide an incentive for inefficient producers to enter one of the markets because since they know that in order for the monopolist to cut prices in the market they are trying to enter, he will be forced to do the same in all the other markets. As a result, they can reasonably expect that the monopolist's response to their entry will never be very strong.¹¹¹

Discriminatory prices when practised by an undertaking in the upstream market, might raise competition concerns downstream, as retailers who are discriminated against by the supplier might find themselves at a competitive disadvantage when their competing rivals pay a lower price for the input.¹¹² This will particularly be the case if the possibilities of arbitrage are constrained and if the cost of the input has a considerable impact on the total costs of the buyer who is being charged the highest price.

Nonetheless, even if that is the case we cannot immediately conclude that the effects on competition are negative. We need to carry out a more rigorous analysis: the exit of one firm might be irrelevant if there are still a number of other sellers competing amongst them.

In fact, the opposite might be the case: a ban on price discrimination might increase upstream monopolists' market power. Two arguments are used to justify this conclusion. The first refers to the fact that the company might

¹¹⁰ SCHERER, F. and ROSS, D., *Industrial Market structure and Economic Performance*, Mifflin Company, Boston, 1990, p. 501.

¹¹¹ MOTTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 499.

¹¹² VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p. 266.

find that it will be unable to exploit its market power (i.e. charging high prices) unless it can credibly commit not to price discriminate. For example, we might imagine a case where the main supplier of a given input individually negotiates the price with retailers. If this supplier tries to sell the input to a certain retailer at a high price, the retailer might prefer not to buy the product if he fears that he will end up competing with other retailers who managed to buy the input at lower prices. If the supplier is allowed to price discriminate, the retailer will fear that as soon as he has bought the input at such a high price, the supplier will lower the price in order to encourage more retailers to buy his product. The retailer will thus refuse to pay such a high price, unless the supplier is able to credibly commit himself not to price discriminate, i.e. not to charge lower prices to the other retailers.¹¹³ Therefore, price discrimination might be pro-competitive when a company with upstream market power supplies downstream customers who compete amongst themselves.

The second argument used to support the idea that a ban on price discrimination might increase an upstream monopolist's market power is based on the fact that if price discrimination is allowed there will be little incentive for retailers to fight for rebates. If price discrimination were illegal, if one of the retailers managed to convince his supplier to grant him a rebate, then all the other retailers would be entitled to it as well. On the other hand, if price discrimination were allowed, all the retailers would have a great incentive to convince the supplier to give them discounts, as these represent a competitive advantage over their rivals. One might then conclude that the legalisation of price discrimination will result in lower prices, as retailers will lobby harder for price cuts.¹¹⁴

¹¹³ O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 560.

¹¹⁴ GEHRIG, T. and STENBACKA, R., "Price discrimination, competition and antitrust", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 201. These authors go as far as arguing that in a competitive environment a ban on price discrimination will enhance the industry's profits, therefore industry lobbies will be tempted to influence legislation so as to keep that prohibition.

A strong argument in favour of not banning price discrimination is that its prohibition might facilitate collusion in an oligopoly. The argument goes that price discrimination increases complexity and will hinder collusion for two reasons: it will increase the difficulty of defining a focal point and it will make the market less transparent.¹¹⁵ For example, in order to enhance the loyalty of their clients, some oligopolists might confer secret rebates on their costumers who buy in big quantities. If word gets out, other suppliers will try to undercut those rebates in order not to lose their clients. These rebates cause list prices to become increasingly unrealistic and will undermine the oligopolists' confidence in their rivals' willingness to cooperate. This will make joint profits unachievable. A point of great relevance is that for this to be true, rebates must be given in an unsystematic manner, as systematic discounts might have the opposite effect - they will weaken competition, by leading to stronger ties between the buyer and the customer, resulting in higher barriers to entry.¹¹⁶

Price discrimination is also beneficial as it can stimulate experimentation in pricing. If a supplier wants to find out the elasticities of demand for his products, the best thing he can do is to implement price changes and then observe their effects on the market. If experimentation means changing the price in all the supplier's markets, it is very likely that he will be extremely reluctant to do so. Price discrimination facilitates these experiences by allowing the supplier to change prices in just one part of the market. If the experiment goes wrong, the adverse effects will be limited to that segment of the market.¹¹⁷

Price discrimination, by increasing producers' profits, may result in a greater degree of investment and innovation. New projects might be

¹¹⁵ GEHRIG, T. and SIENBACKA, R., "Price discrimination, competition and antitrust", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 202.

¹¹⁶ SCHERER, F. and ROSS, D., *Industrial Market structure and Economic Performance*, Mifflin Company, Boston, 1990; VISCUSI, W., HARRINGTON, J., VERNON, J., *Economics of Regulation and Antitrust*, 4th ed., The MIT Press, Cambridge, 2005, p. 349.

¹¹⁷ SCHERER, F. and ROSS, D., *Industrial Market structure and Economic Performance*, Mifflin Company, Boston, 1990, p. 500.

undertaken that would not otherwise have been. These new investments will most likely result in additional pro-competitive effects in the future and will also benefit consumers, even if they had to pay higher prices initially.¹¹⁸

3.2.3 Effects of price discrimination on market integration.

As noted above, achieving the Single Market is a political goal which is not always in line with economic welfare. These two aims may, on certain occasions, conflict with each other. As we saw under third-degree price discrimination, if a firm - selling a product in two different countries and charging a much higher price in one of the countries - is forced to adopt a uniform price, then it might find it more profitable to abandon the market where it was charging the lower price and solely sell in the other market, maintaining the high price it was previously charging. This situation is clearly welfare detrimental, as a group of consumers is no longer supplied.

However, even looking solely at the aim of market integration, banning price discrimination might not always contribute to the attainment of this goal, if it means the abandonment of certain national markets when firms are forced to charge a uniform price. The differences in the two countries will end up even more pronounced than before: before, the difference was based on the fact that the price for the same good was cheaper in one country than the other; after, the difference will be that the product can be purchased in one country but not in the other.

Once again we come to the conclusion that a *per se* rule prohibiting price discrimination is unjustified not only on welfare grounds but also in reference to the goal of market integration.¹¹⁹

¹¹⁸ GEHRIG, T. and SIENBACKA, R., "Price discrimination, competition and antitrust", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 134.

¹¹⁹ MOYTA, M., *Competition Policy Theory and Practice*, Cambridge University Press, New York, 2004, p. 23.

3.2.4 Fairness.

A ban on price discrimination is sometimes justified on the basis that every customer should pay the same for comparable transactions. That amounts to saying that the price should not depend on the valuation given by the consumer.¹²⁰

In relation to this argument it must first of all be stated that micro-economics does not usually address the issue of fairness. Instead, it analyses conduct from the perspective of economic efficiency and does not look at whether the practice is "fair".¹²¹ Nonetheless, looking at price discrimination from this angle, the truth is that if instead of discriminatory prices, uniform prices are used – this might end up benefiting the high-valuation buyers, as a market with uniform prices means that low-valuation costumers (i.e. those with valuations that barely exceed the marginal costs¹²²) will not buy the product. Therefore, one cannot say that uniform prices guarantee equal access to the market.¹²³

3.2.4.1 Income distribution.

Price discrimination means higher profits for the discriminatory producer. This can be seen as causing a redistribution of income from customers to the seller. Whether this is a good or a bad thing is debatable. The idea that it is bad because it moves wealth from poor consumers to rich corporate stockholders is quite a subjective viewpoint, and one that is not always

¹²⁰ GEHRIG, T. and SIENBACKA, R., "Price discrimination, competition and antitrust", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 140.

¹²¹ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 198.

¹²² As we have seen, although under perfect competition conditions prices should equal marginal costs, this rarely happens in the real world.

¹²³ GEHRIG, T. and SIENBACKA, R., "Price discrimination, competition and antitrust", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 140.

correct¹²⁴ Furthermore, customers who pay more under first- and third-degree price discrimination systems are those with a greater willingness to pay and are therefore likely to be on average wealthier than those demonstrating a lower willingness to pay.¹²⁵

3.2.4.2 Protection of small firms.

The question of whether price discrimination when practised by a dominant firm hurts and drives out small competitors is related to the already discussed issue of whether discrimination can be used as a monopolisation device. The problem of protecting small and inefficient firms has also already been dealt with.¹²⁶

4 ANALYSIS OF ECJ CASES ON DISCRIMINATORY PRICES.

B. THE AIRPORT CASES

We shall now analyse one ECJ case and three Commission's decisions where action was taken against a dominant undertaking for abusing its position for price discriminating amongst its trading partners.

¹²⁴ This issue relates to the discussion what standard of welfare should competition law drive for: total economic welfare or consumer welfare.

¹²⁵ BISHOP, S. and WALKER, M., *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London, 2002, p. 197; SCHERER, F. and ROSS, D., *Industrial Market structure and Economic Performance*, Mifflin Company, Boston, 1990, p. 494.

¹²⁶ See point 3.2.2., p. 24.

4.1 BELGIAN¹²⁷, PORTUGUESE¹²⁸ AND SPANISH AIRPORTS.¹²⁹

The facts in these three cases are quite similar. In the three Member States concerned, airports are managed by public undertakings¹³⁰. These public undertakings charge fees to aeroplanes landing and taking-off in return for the services that they provide.¹³¹ These fees are calculated in relation to the weight of the aircraft. The problem was that these undertakings used a system of discounts based on landing frequency. These systems were non-linear, with high thresholds and progressive stages.¹³² Furthermore, both the Spanish and the Portuguese undertakings applied a differentiated - more beneficial - charge to domestic flights.¹³³

The Commission took action by adopting decisions condemning such practices and ordering that they should be stopped. The Commission argued that these undertakings enjoyed a dominant position in their respective markets.¹³⁴ The Commission relied on Articles 86 and 82 of the

¹²⁷ Commission Decision of 12.09.95, *Belgian Airports*, O.J. L 216/8.

¹²⁸ Commission Decision of 10.02.99, *Portuguese Airports*, O.J. L 69/31.

¹²⁹ Commission Decision of 26.07.00, *Spanish Airports*, O.J. L 208/36.

¹³⁰ Airways Authority in Belgium; ANA-EP in Portugal and AENA in Spain.

¹³¹ The charge is supposed to cover all "operational and maintenance costs and administrative costs attributable to those areas and their associated vehicles and equipment, including the expense of all labour, maintenance materials, powers and fuels", Commission Decision of 26.07.00, *Spanish Airports*, O.J. L 208/36, § 17.

¹³² For example, under the Belgian system the fees due were reduced by 7.5% if the amount due was between 5 - 10 million Bfrs; 15% were the amount was between 10-15 million Bfrs; 20% when between 15 - 20 million Bfrs; and 30% on amounts over 20 million Bfrs. Commission Decision of 12.09.95, *Belgian Airports*, O.J. L 216/8, § 1.

¹³³ For example, in the Portuguese case, domestic flights were allowed a reduction of 50% on landing charges.

¹³⁴ The relevant market in the three cases was defined as "the market in services linked to access to airport infrastructure for which a fee is payable" (*Spanish Airports* Decision, § 33; *Belgian Airports* Decision, § 7 and *Portuguese Airports* Decision, § 14) by reference to the Judgment of the European Court of Justice of 10 December 1991, C-179/90, *Merzi Convenzionale Porto di Genova v. Siderurgia Gabrilelli*, ECR [1991] I-07889, § 15, where it was held that the "organisation of port activities for third parties at

Treaty to reach the conclusion that such practices were incompatible with EC law. Article 86 states that in the case of public undertakings, "Member States shall neither enact or maintain in force any measure contrary to the rules" of the Treaty. Article 82, as we have seen, considers price discrimination as an abuse when practiced by dominant firms.

Unlike Spain and Belgium, Portugal appealed against the Commission Decision to the ECJ, asking for its annulment. The Court dismissed the Portuguese appeal and considered that the Commission was right in finding that the public undertaking had abused its dominant position.¹³⁵

4.1.1 Economic analysis.

If we refer back to the conditions necessary for a firm to discriminate, we can see that they are present in this case. First of all, the discriminatory undertakings have market power, since they are all monopolists. Secondly, there are no opportunities for arbitrage, as we are dealing with services. Thirdly, the undertakings have information on their customers, i.e. they know which airlines are using the airport, how frequently and how willing they are to use it.

These cases refer to price-discrimination in secondary line injury situations, as the discriminatory practices potentially affect the conditions of competition on downstream markets and not the condition on the market where the undertaking is active.

The discriminatory practices are applied by non vertically-integrated operators. They do not contain elements of extension or leveraging of

a single port may constitute a relevant market for the purposes of Article 82". In the cases under analysis, the dominant position attributed to the undertakings was based on the fact that they enjoy a legal monopoly to provide certain services. Furthermore, those services were considered as a substantial part of the common-market and capable of affecting trade between Member States.

¹³⁵ Judgment of the European Court of Justice of 29 March 2001, C-163/99, *Portuguese Republic v. Commission*, ECR [2001] p. I-2613.

dominant position. They represent clear examples of discrimination by a supplier between its trading partners.¹³⁶

At first sight, it seems rather strange why a non-vertically integrated undertaking would want to discriminate amongst its trading partners. Non-vertically integrated firms benefit from a competitive market. If the upstream operator protects one of the downstream firms too much, the other firms will find it hard to compete with the latter and will end up being driven out of the market. This would give the downstream firm significant countervailing buyer power which would, logically, run counter to the interests of the upstream undertaking, who would see its market power diminished.¹³⁷ However a more in-depth analysis might reveal reasons (such as fixed cost recovery¹³⁸ or to undermine an oligopoly¹³⁹) why a firm would want to discriminate among its customers.

¹³⁶ GERARDIN, G. and PÉTHI, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series* [2005], pp. 26-32.

¹³⁷ GERARDIN, G. and PÉTHI, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series* [2005], p. 33.

¹³⁸ See points 3.2.1.1 and 3.2.1.2.

¹³⁹ If the downstream market is composed of a collusive oligopoly, these firms can use their joint power to impose on the supplier sub-competitive prices for input and charge supra-competitive prices on consumers. This will lead to a decrease in output: the supplier will be less willing to produce for lower prices and the consumers less willing to buy at higher prices. It will thus be in the interest of the supplier to try to give a more beneficial treatment to one of the oligopolists, as this will undermine the collusion downstream and make it more necessary for retailers to increase output. This also represents more orders to the seller. GERARDIN, G. and PÉTHI, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series* (2005), p. 33-34.

4.1.1.1 Why are discounts an abuse?

In the appeal to the ECJ, Portugal argued that its system of discounts based on the frequency of landings was not an infringement of Article 82. The system was justifiable, first of all because quantity discounts constitute a normal business practice and, secondly, given the high level of investments airports have to undertake and the need to recoup the capital invested, it is in their interest to encourage airlines to use their facilities as much as possible.¹⁴⁰ Similar arguments were used by the Belgian authorities who had argued that they had the right to introduce a system of reductions as part of their commercial policy and that they had the right to grant larger discounts to their loyal costumers, particular in view of the financial security they provide.¹⁴¹

The response of the Commission was that it does not oppose the granting of quantity discounts by dominant undertakings to their trading partners as long as they are "justified on objective grounds, that it is to say, they should enable the undertaking in question to make economies of scale".¹⁴²

The ECJ supported the Commission's finding, confirming that

"an undertaking occupying a dominant position is entitled to offer its customers quantity discounts linked solely to the volume of purchases made from it".

The system in question, with its various discount thresholds, benefits only some trading partners, giving them an economic advantage that is not justified on the basis of economies of scale.¹⁴³

Declarations like these are commonly repeated by the Commission and by the Court. For example in *Michelin*¹⁴⁴ the Court stated that

¹⁴⁰ Judgment of the European Court of Justice of 29 March 2001, C-163/99, *Portuguese Republic v. Commission*, ECR [2001] p I-2613, § 48.

¹⁴¹ Commission Decision of 12.09.95, *Belgian Airports*, O.J. L 216/8. § 16.

¹⁴² Judgment of the European Court of Justice of 29 March 2001, C-163/99, *Portuguese Republic v. Commission*, ECR [2001] p. I-2613, § 49.

¹⁴³ *Ibidem*, §§ 50, 51 and 52.

"with the exception of short term measures, no discount should be granted unless linked to a genuine cost reduction in the manufacturer's costs".

Many economists agree that such statements are "alarming"¹⁴⁵. A rule requiring that dominant firms should earn equal price-cost mark-ups on all their transactions would be extremely restrictive and would lead to inefficient outcomes in the case of fixed-cost recovery industries.¹⁴⁶ There is no economic rationale for such a rule. It cannot be concluded that a system of discounts which is not "cost-justified" harms competition. Furthermore, most discounts have no specific relation between the discount's size and cost savings made by the dominant firm. And such a relationship would always prove extremely hard to prove.¹⁴⁷ The idea that reductions in price must be "cost-justified" makes sense only if we are trying to prevent predatory prices, but the Court has already developed special rules to deal with these cases.¹⁴⁸

¹⁴⁴ Judgment of the European Court of Justice of 9 November 1983, C-322/81, *NV Nederlandsche Banden Industrie Michelin v. Commission*, ("Michelin I") ECR [1983] p. 3461.

¹⁴⁵ RIDYARD, D., "Exclusionary Pricing and Price Discrimination Abuses Under Article 82 - An Economic Analysis", *European Competition Law Review* 6 (2002) p. 286.

¹⁴⁶ *Ibidem*.

¹⁴⁷ O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford 2006, p. 376. Difficulties that would arise when trying to "cost-justify" discounts would include the choosing of a methodology for measuring costs; how to attribute cost savings to each customer and the need to decide what is the appropriate time period to recover fixed costs. WAELBROECK, D., "Michelin II: A per se rule against rebates by dominant companies?", *Journal of Competition Law and Economics*, (2005) pp. 149-171.

¹⁴⁸ *Meeting Competition, The Great Contradiction*. Competition memo, Lexecon, London, 1999. Available at <http://www.crai.com/ecp/publications/archive.htm>; The rule used by the Community Courts and the Commission on predatory prices was defined in the famous AKZO case (Judgement of the European Court of Justice of 3 July 1991, C-62/86, ECR [1991] p. I-3359) and can be described as follows: when the dominant firm is charging above ATC, it cannot be found guilty of predation; where the price is below ATC but above AVC, the firm will be found

As the Portuguese and the Belgian authorities claimed, quantity discounts are a common business practice and as we have argued in this article, price discrimination might be welfare enhancing and can be justified by several pro-competitive reasons.¹⁴⁹ In fact, many economists would not see "volume-based" discounts, such as the ones used by the airports, as discriminatory: the criteria for getting the rebate is transparent and open to anyone who manages to reach the respective threshold. In a certain sense, equivalent transactions are not treated in a dissimilar way.¹⁵⁰ For example: if TAP and BA both make a total number of 500 landings, they will both get exactly the same discount.

guilty of predation where this is part of a plan to eliminate competitors; and when the prices are below AVC, the firm will be presumed to be abusing its dominant position, unless it can objectively justify such prices. WHISH, R., *Competition Law*, 5th ed., Oxford University Press, 2005, p. 706.

¹⁴⁹ When dealing with cases on loyalty discounts (ex. *BA/Virgin* and *Michelin*), the Commission and the Community Courts seem to presume that a dominant undertaking would only use them to unlawfully exclude its competitors or to foreclose the market. However, there could well be various pro-competitive reasons why a dominant undertaking would choose to use loyalty discounts (however, not all can be transposed to the case under analysis). These include: recovery of fixed costs; better incentives for retailers; avoiding double marginalisation (which refers to the problem that if both the supplier and the retailer have monopoly power, the supplier will sell the good to the retailer at a monopoly level, to which the retailer will add its own mark-up cost, resulting in very high prices to consumers and a decrease in output); securing the largest customers (which was one of the arguments used in the *Belgian* case); solving "hold-up" problems... This, however, does not mean that rebates are good for competition. Under certain circumstances rebates may, indeed, lead to the exclusion of rivals and to market foreclosure. O'DONOGHUE, R and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p.374-381; VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, pp. 262-264.

¹⁵⁰ RYDIARD, D., "Exclusionary Pricing and Price Discrimination Abuses under Article 82 - An Economic analysis", *European Competition Law Review*, 6 (2002) p. 287.

The problem with these cases, as well as all others dealing with price discrimination and discounts, is that the Community Courts and the Commission do not carry out an economics-based analysis of the conduct they considered as abusive. The relevant question when dealing with quantity discounts should be whether the practices adopted by the dominant firm are exclusionary and whether they adversely affected consumers through higher prices and lower quality and choice.¹⁵¹ However, this question is never analysed by the Commission or the Community Courts. For example, in *BA/Virgin*, when dealing with BA's argument that the Commission had failed to demonstrate the exclusionary effect that its practices had on the market, the CFI stated as follows:

*"In the first place, for the purposes of establishing an infringement of Article 82 EC, it is not necessary to demonstrate that the abuse in question had a concrete effect on the markets concerned. It is sufficient in that respect to demonstrate that the abusive conduct of the undertaking in a dominant position tends to restrict competition, or, in other words, that the conduct is capable of having, or likely to have, such an effect."*¹⁵²

Similarly, in the *Portuguese* case, the ECJ basically reasoned that because the differences in discounts could not be justified in terms of economies of scale, they represented a discriminatory treatment, and were therefore abusive. The Court did not look at the effects that these discounts were having on competition. The system of discounts ended up favouring airlines that used the airport more frequently, which meant that TAP and Portugalia, the national airlines, were given the most favourable treatment. But did the favouring of these airlines end up having exclusionary effects? Were airlines being forced out of the market?

If we look at the case from the consumer welfare perspective, Portugal had argued that the system was designed to encourage airlines to increase their use of the airport facilities. This means that the system was designed to increase output – increase the number of flights. Greater discounts also

¹⁵¹ O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 396.

¹⁵² Judgment of the Court of First Instance of 17 December 2003, T-219/99, *British Airways plc. v Commission* ECR [2003] p. II-5917, § 293.

represent lower costs and therefore the airlines will be able to charge lower prices for the tickets. Increased output and lower prices, clearly means improved consumer welfare.

Another aspect we might look at is the different treatment given to domestic flights when compared to international flights. Both the Court and the Commission found that the 50% discount given to domestic flights constituted an abuse. It must be said that when analysing the impact of this measure we should look at the impact that it is having on competitors. But all the airlines that operate domestic flights receive the 50% reduction. Which competitors does the public undertaking discriminate against? According to the Court:

*"this type of measure confers an advantage on carriers who operate more than others on domestic rather than international routes and so leads to dissimilar treatment being applied to equivalent transactions"*¹⁵³.

However, we have doubts on whether domestic and international flights may be considered as "equivalent transactions", or to put it in another way, are carriers that operate domestic flights competing against carriers that operate international flights? Do they constitute the same market?

Although the argument was not used by the appellant, the system of discounts for domestic flights might be justified in terms of a Ramsey pricing logic: undertakings responsible for airport management incur heavy fixed costs and need to recoup their investments, therefore they will try to use a pricing scheme that best allows them to do so. This pricing scheme normally involves charging higher prices to customers with more inelastic demand and lower prices to those with more elastic demand. It might be that domestic flights are much more price sensitive than international flights, as there are other forms of transport – such as railways or road transport – that constitute effective substitutes to airlines. If airlines operating domestic routes are faced with high fees, they might have to increase the price of their tickets. Passengers will then change to other

¹⁵³ Judgment of the European Court of Justice of 29 March 2001, C-163/99, *Portuguese Republic v. Commission*, ECR [2001] I-2613, § 66.

forms of transport. The airlines will reduce the number of flights and the airport suffers as a result.

This principle can also be applied to discounts in international flights. The additional demand that the price reduction triggers is more elastic than the first flights which are based on existing demand. The price reduction aims at expanding final demand and serves consumers with low purchasing power, that otherwise would not have taken the flight.

4.1.1.2 Discrimination on grounds of nationality.

However, if it is true that the economic analysis was misapplied or not applied at all in the airport cases, it should be noted that all of these cases involved a particular "political" aspect - the system of discounts seems to have been designed to indirectly favour national airlines. In theory the discount system was open to everyone, but the airport authorities knew that only the national carriers would be able to reach the highest thresholds.

To put it in another way, although these cases are clear examples of the concept of secondary line price discrimination, they are not "genuine" cases because they all involved an element of discrimination on grounds of nationality.¹⁵⁴

This factor was clearly recognised by the Commission in the *Belgian Airports Decision*

"While most of the abuses committed by undertakings in a dominant position are designed to maximize their profits or strengthen their dominance, Article 86 [now article 82] also applies to cases in which an undertaking in a dominant position discriminates against its partners for reasons other than its own interests. This may involve, for example, giving preference to an undertaking from the same State [...]. Thus in the case at issue,

¹⁵⁴ GERARDIN, G. and PEH, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series* [2005], p. 32.

unlike the case of the systems of so-called loyalty rebates examined by the Court [...], the airways authority is not attempting to obtain the loyalty of its costumers or to attract new ones, [...], but rather the State, acting through its intermediary, is giving preferential treatment to a specific undertaking, i.e. the national airline Sabena".¹⁵⁵

In fact, discrimination on the grounds of nationality violates one of the core objectives of the EC Treaty, contained in Article 12 of the EC Treaty.¹⁵⁶ According to some,¹⁵⁷ when the Treaty was designed, the authors felt the need to echo the prohibition on discrimination on the grounds of nationality in the chapter on competition. Article 82 (c) was, therefore, specifically introduced to prevent discrimination on the grounds of nationality, as the existence at that time of various state monopolies raised the concern that these would lead to national interests being favoured. This would run counter to the attainment of the Single Market, by maintaining national markets separated.¹⁵⁸ It seems that in cases where discrimination is

¹⁵⁵ Commission Decision of 12.09.95, *Belgian Airports*, [1995] O.J. L 216/8, §§ 17, 18. The Cases referred by the Commission are *Hoffman La Roche* (Judgement of the European Court of Justice of 13 February 1976, C-85/76, ECR [1979] p. 461, and *Michelin* (Judgement of the European Court of Justice of 9 November 1983, C-322/81, ECR [1983] p. 3461).

¹⁵⁶ Art. 12 of the EC Treaty states that "Within the scope of application of this Treaty and without prejudice to any special provision contained therein, any discrimination on grounds of nationality shall be prohibited".

¹⁵⁷ O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 573.

¹⁵⁸ LANG, J., "Anticompetitive Non-Pricing Abuses under European and National Antitrust Law", *International Antitrust Law & Policy*, (2003) p. 235-240. Art. 82 (c) seems to have been influenced by art. 60 (1) of the no longer applicable ECSC Treaty, according to which "pricing practices...shall be prohibited, in particular: [...] discriminatory practices involving, within the common market, the application by a seller of dissimilar conditions to comparable transactions, especially on grounds of the nationality of the buyer".

based on grounds of nationality, since it violates one of the main principles of EC law, there would be no need to carry out an effects analysis.¹⁵⁹

However, what is quite surprising and rather confusing in the Portuguese case is that when Portugal argued that the system of discounts did not discriminate on grounds of nationality, the Commission replied that it had never made such a claim and that Article 82 of the Treaty made no reference to the existence of such discrimination.¹⁶⁰ The Court backed up the Commission, stating that,

*"subparagraph (c) of the second paragraph of Article 86 [now Article 82] of the Treaty prohibits any discrimination on the part of an undertaking in a dominant position which consists in the application of dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage, irrespective of whether such discrimination is linked to nationality".*¹⁶¹

The Court therefore went on to conclude that the Portuguese argument that the system does not discriminate on the basis of nationality does not make it possible to rule on the invalidity of the Decision. The judgment is rather confusing, because the Court also acknowledged that in practice the system benefited the Portuguese airlines.¹⁶² In our view, this is clearly a case of indirect discrimination on nationality grounds.

After dismissing the Portuguese argument that the system did not discriminate on nationality grounds, the Court then embarked on the

¹⁵⁹O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 578 and Commission Decision of 20.08.99, *Football World Cup*, O.J. L 5/55, at §100.

¹⁶⁰ Judgment of the European Court of Justice of 29 March 2001, C-163/99, *Portuguese Republic v. Commission*, ECR [2001] p. I-2613, §§ 43, 44.

¹⁶¹ Judgment of the European Court of Justice of 29 March 2001, C-163/99, *Portuguese Republic v. Commission*, ECR [2001] p. I-2613, § 50.

¹⁶² Judgment of the European Court of Justice of 29 March 2001, C-163/99, *Portuguese Republic v. Commission*, ECR [2001] p. I-2613, § 57: "Under such circumstances the conclusion must be that the system in question discriminates in favour of TAP and Portugalia".

analysis that has just been seen (and criticized), namely whether those discounts could be objectively cost-justified. In doing so, it relied on *Michelin*, which, as the Commission rightly observed in the *Belgian* decision, involved different kinds of problems.¹⁶³

4.1.1.3 Is Article 82 c) the right legal basis when dealing with discrimination on grounds of nationality?

A different question is whether competition rules, or more precisely Article 82 (c), should be used to prohibit discriminatory treatment on the grounds of nationality. Authors who argue that the objectives of competition law should only be to ensure efficiency and consumer welfare, will be very reluctant to apply Article 82 to cases such as the airport cases.¹⁶⁴ However, as we have seen, historically Article 82 (c) was adopted to deal with discriminatory treatment on the grounds of nationality. Some authors, therefore, claim that cases such as the airport cases have been rightly condemned under this legal provision; since they violate a core principle of EC law, they should be subjected to strict rules. And they raise doubts as to whether such conduct could be condemned using a different legal basis, such as Article 12 of the EC Treaty.¹⁶⁵ We share this view.

It is interesting to note that these measures might also be seen as a discrete tool to aid national undertakings. Some authors question the need to rely

¹⁶³ They involve different economic issues, where one involves discrimination between airlines by the airport authorities, i.e. relates to conditions in the downstream market, *Michelin I* related to the exclusion of rivals at the same level of the market. In other words, Michelin's behaviour was impeding his rivals access to the market. WAELEBROECK, D., "Michelin II: A per se rule against rebates by dominant companies?", *Journal of Competition Law and Economics*, (2005) p. 4.

¹⁶⁴ VAN DER BERGH, R. J. and CAMESASCA, P. D., *European Competition Law and Economics, A Comparative Perspective*, 2nd ed., Sweet & Maxwell, London, 2006, p. 47.

¹⁶⁵ GERARDIN, G. and PÉRIE, N., "Price Discrimination under EC Competition Law: The Need for a case-by-case Approach", *The Global Competition Law Centre Working Paper Series* [2005], p. 33; O'DONOGHUE, R. and PADILLA, A. J., *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford, 2006, p. 578.

on specific anti-discrimination rules, arguing that the law on state aid would seem to be sufficient.¹⁶⁶

4.2 FINAL REMARKS.

The ECJ judgment in *Portuguese Airports* clearly lacks clarity and coherence. Both the Commission and the Court denied accusing Portugal of discriminating among airlines on a nationality basis, but they ultimately declared that the airport authorities should abolish the landing system since in practice it favoured the national carriers.

It would perhaps have been clearer if the Court had expressly held that the discount system was indirectly discriminatory on the basis of nationality. In other words, although the system was not directly discriminatory – the measure did not discriminate on a nationality basis *prima facie* as theoretically every carrier that reached a certain threshold obtained the discount – it seems to have been designed knowing that only the national carriers would be able to reach the highest number of landings, hence the greater discounts. Indirect discrimination on nationality grounds infringes one core principle of EC law, contained in Article 12 of the Treaty. Article 82 (c), apparently for historical and political reasons, also applies to cases such as these. The problem at stake does not concern consumer welfare or economic efficiency, but rather a more political issue: prohibiting discrimination on a nationality basis and the attaining of the single market.

Another possible solution was to analyse the case as a “state-aid” problem. In fact, the Commission adopted Guidelines in 1994¹⁶⁷ and in 2005¹⁶⁸ which

¹⁶⁶ SPECTOR, D., “The Strategic Uses of Price Discrimination”, in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 205, foot note 29.

¹⁶⁷ Commission Guidelines, *Application of Articles 92 and 93 of the EC Treaty and Article 61 of the EEA Agreement to State Aids in the aviation sector*, O.J. 1994 C-350/5.

¹⁶⁸ Commission Communication of 06.09.2005, *Community guidelines on financing of airports and start-up-aid to airlines departing from regional airports*. Available at http://europa.eu.int/comm/dgs/energy_transport/state_aid/doc/2005_09_06_aviation_guidelines_en.pdf.

treat this problem from a state aid perspective. The 1994 Guidelines declared that the construction of airport infrastructures is an economic policy measure, and therefore outside of the Commission's scope. But this does not apply "to the evaluation of possible aid elements resulting from preferential treatment of specific companies when using the infrastructure".¹⁶⁹

In this case, the Court did not choose to use this option. Instead, it argued that the discount system had to be cost-justified. This reasoning is not in line with economic theory. The problem is that such reasoning, along with the frequent practice of the ECJ and the Commission of finding discriminatory prices by dominant firms as a *per se* abuse, and thus finding that there is no need to examine the effects of that conduct on the market, may have the adverse effect of prohibiting pro-competitive behaviour.

Indeed, the Commission has been using a much more economics-based analysis in Article 81 and merger control cases than in Article 82 cases. That said, a step forward has been taken with the launch of the discussion paper on the reform of Article 82, but there is still some way to go. Under this paper, a distinction is made between different two types of discounts, it being recognized that both of them may be either efficient and pro-competitive or anticompetitive. However, criticism has been raised of the discussion paper, it being argued that it is extremely difficult, if not even impossible, to apply in practice.

Returning to the airports' cases, an interesting question to ask is whether future cases dealing specifically with this problem should not be analysed differently. These cases date back to the 1990's and the airline industry has clearly gone through great changes in recent years, with the failure of

¹⁶⁹ BARTOSCH, A., "Distortions of Competition on the Markets for the Operation of Airports Infrastructures: the Commission's New guidelines", (2005) 4 *European State Aid Law Quarterly*. 621; SPECTOR, D., "The Strategic Uses of Price Discrimination", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 205. However, it is interesting to note that the Court claims that Portugal might have had a case if it had argued that the service in question was one of general economic interest and that the application of such rules to this case, would render the provision of the service impossible.

various national carriers (such as Sabena and Swiss Air), the appearance of fierce and highly competitive low-cost carriers and deregulation of the skies. These carriers operate in a different way. Whereas national carriers will normally have their hub in one of the airports of their country, the same does not hold true for the low-cost airlines.¹⁷⁰ Their business models are different and this has an impact on where they choose to locate their activities. This will probably lead to a broader definition of the market than the one that was used under these cases, as these airlines will choose as their hubs airports offering the best conditions, independently of whether they are located on national soil. Airports eager to attract these airlines will try to offer them the best conditions, i.e. lower taxes. This means that the airports end up competing with each other, making it difficult to define dominance only in relation to a national market. Therefore, it seems that (i) market power should be analysed in relation to a wider-than-national market, possibly including the whole European area, and (ii) airport authorities will have less or no incentives to favour national carriers as they will want to develop schemes to make themselves more attractive to the "foreign" low-cost operators. In this new world, a more in-depth economics-based analysis would therefore seem to be all the more necessary.

5 CONCLUSION.

Price discrimination is a broad and complex concept, present in various types of business practices. Its effects on economic welfare and competition are quite ambiguous, making it difficult to say *a priori* whether it is a good or bad thing. Furthermore, even when analysed in terms of income distribution or fairness it is not that easy to justify a ban on price discrimination.

The problem is that in cases where price discrimination is beneficial to economic efficiency or the competitive process, a *per se* ban on such a

¹⁷⁰ For example, Ryanair is of Irish nationality, but has hubs in places like Valencia, Porto, Stockholm, Gerona or Milan. It has recently announced its 27th European base. Available at <http://www.ryanair.com/site/EN/news.php?yr=08&month=feb&story?rte-en-280208>.

practice will have adverse effects. Strong penalties are likely to deter competitive behaviour¹⁷¹ and hinder undertakings' incentives to invest in research and development. We therefore argue that an effects-based analysis, i.e. a case-by-case approach, should be taken before a dominant undertaking is banned from carrying on a specific practice. These effects should in particular look at whether the practice has exclusionary results in the market in which the undertaking is active or in adjacent markets.¹⁷² The potential efficiency benefits should be enough to prevail over the argument that this might mean a less clear rule, and perhaps a less practical one.¹⁷³

The Commission and the Community Courts usually take a hostile stance towards price discrimination and try to justify its prohibition with arguments that are not always in line with economic theory. Furthermore, when examining such cases, one must always have in mind that EC competition law has various objectives. And since they are not all economic in nature, conflicts might arise. The *Portuguese airports* case is an example of this. These cases cannot be solely explained on efficiency or welfare grounds. Although some argue that they should be, the fact is that EC competition law is not only about that. If that were the case, it would be much easier and simpler to design competition rules.¹⁷⁴ But that would make competition policy quite economics-based and lawyers would not sleep easily at such a prospect!

¹⁷¹ RIDYARD, D., "Exclusionary Pricing and Price Discrimination Abuses Under Article 82 - An Economic Analysis", *European Competition Law Review* 6 (2002) p. 29.

¹⁷² PERROI, A., "Towards an effects-based approach of price discrimination", in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, Stockholm, 2005, p. 164.

¹⁷³ FREDERICO, G., "When are Rebates Exclusionary", *European Competition Law Review* 9 (2005) p. 477. This author admits that the task of examining potential exclusionary effects of rebates might not be an easy one, but it is feasible and capable of giving very useful information on its potential impact on consumers and in competition.

¹⁷⁴ WHISH, R., *Competition Law*, 5th ed., Oxford University Press, 2005, p. 17.