

Case law developments: A new approach to price discrimination?

Postal pricing in commercial contracts

A briefing by
Copenhagen Economics

October 2013



Introduction

Case law on competition is in continuous evolution. In a series of landmark cases in the postal sector, competition courts and agencies have clarified the boundaries of a dominant company's behaviour relative to pricing rebates and price discrimination. These decisions have an impact on both companies with a historical incumbent position and on the companies which compete with them in the same markets.

The legal and economic implications of these recent cases apply to all situations where a dominant position exists. The new case law is likely to affect more immediately the postal and delivery markets, which is the focus of this update brief. Specifically, the key question discussed here is whether the new case law brings a new approach to price discrimination, i.e. practices where customers are charged different prices for the same service

Pricing towards mailers:

Price discrimination by a dominant company is the key issue in the first case law development reviewed here. In 2004 Post Danmark (Post DK) won the three largest customers from FK, its competitor in the market for distribution of unaddressed items. Post DK acquired these customers by offering them lower prices than those charged to its other customers. There was no cost difference to justify the price difference; hence it was a matter of price discrimination by use of selective rebates.

Based on a response from the ECJ, in early 2013 the Danish Supreme Court quashed a previous finding that Post DK had abused its dominance. The ECJ response had stated:

*“ ‘**price discrimination**’, that is to say, charging different customers or different classes of customers different prices for goods or services whose costs are the same or, conversely, charging a single price to customers for whom supply costs differ, **cannot of itself suggest** that there exists **an exclusionary abuse**”* (Case C-209/10, Judgment, para 30)

Price discrimination is not a problem as long as it does not prevent as-efficient competitors from competing. When describing the boundaries for efficient competition, the ECJ referred to the AKZO criteria for predatory pricing. The AKZO criteria imply:

- Abuse of dominance, if prices are set below average incremental costs
- Abuse of dominance, if prices are set above average incremental costs but below total average costs AND intent to eliminate competition can be proven
- No abuse of dominance, if prices are above average total cost

Post DK's prices were above average incremental costs, but below total average costs. Thus, the key question became whether Post DK had intent to eliminate its competitor FK. The Danish Supreme Court concluded that there was no evidence of elimination intent.

The decision provides important contributions to case law, since it clearly states that:

- The relevant criterion is whether competitors as efficient as the dominant firm can compete in the market. This implies that less efficient competitors should not be protected.
- It clearly states that the predatory pricing test is the only test to assess whether low prices are abusive.

Furthermore, the decision acknowledges incremental costs as the relevant cost benchmark. For this reason, the economic strategy to ascertaining costs is a fundamental consideration for any party considering a competition case, as discussed in Box 1.

Box 1 Effective ways to ascertain costs in competition cases

Price-cost tests relying on a top-down approach are somewhat problematic. Under this approach, costs are derived from aggregated financial data using the fully distributed costing method – which is obligatory under the Postal Directive. This top-down methodology relies on the operator's accounting system and it can be difficult for authorities to interpret the information and to extract the information they need for their competition assessment. For example, the accounting system may not allow for the cost split that is needed for a particular competition case.

An alternative way to ascertaining costs could be to use a so-called bottom-up approach. In the so-called bottom-up approach, costs are calculated based on measures for elementary activities (e.g. number of visits to mailboxes) multiplied by unit costs for the different resources (e.g. cost per visit per mailbox). The costs of elementary activities are then aggregated to establish the costs for the relevant service.

The bottom-up approach allows the authorities to cross-check the top-down data provided by the postal operator, cf. ERGP. Good practice in this respect is demonstrated for instance by Denmark and Germany, where the NCAs have applied price cost tests supported by bottom-up cost calculations.

Source: Copenhagen Economics, *Pricing behaviour of postal operators* (2012), a report prepared for the European Commission, DG Internal Market and Services

In summary, the Post Danmark case demonstrates that the ECJ does not consider discrimination as a competition problem as of itself. The next question is whether national agencies have shared this view. Besides price discrimination affecting the mailers (end users of the delivery service), several national cases (prior to the ECJ ruling) have also reviewed discrimination towards mail intermediaries, also known as mail consolidators.

Pricing towards consolidators

The key findings and implications of national consolidator cases are relevant to the key question discussed here: whether the recent case law brings a new approach to price discrimination?

In a regulatory case (in 2007) under the old Postal Services directive, La Poste had been cleared to block consolidators from obtaining volume discounts (offered instead to its large business customers). The agency cleared the discriminatory practice examined, on the basis that it stimulated demand. This case was in line with the argument that discrimination is not an abuse in itself.

More recently, however, somewhat similar practices towards consolidators by two other incumbent postal operators (Posta Romana and bpost) have led their national competition agencies to find an abuse of dominance and issue fines of €24m and €37m, respectively.¹ Superficially, these rulings might indicate an assessment of discrimination in full contrast with the *La Poste* case. Yet, we find important differences.

Since 2008, Posta Romana restricted or reduced discounts for consolidators, for both direct and bulk mail. It justified this by arguing (as per the *La Poste* case) that consolidators do not create economic welfare since they do not expand demand. However, these arguments did not convince the national competition agency, which in 2010 found that Posta Romana's discount policy was not only exploitative but also had an exclusionary effect by raising rivals' costs on the upstream markets, which were thus distorted. This ruling does not sanction discrimination *per se*, but the exclusion of an upstream rival.

In Belgium, bpost revised in 2010 its discounting policy for direct mail and admin mail, both within the USO. Unlike rebates to original senders (based on total volume), rebates to consolidators were now based on each sender's (separate) volume. Moreover, consolidators could only obtain rebates if they identified their clients. Finally, bpost applied discounts not at the margin but retroactively on the entire amount purchased. In December 2012, the Belgian competition agency found this policy to be abusive.

The agency stated explicitly that discrimination, while an important factor, did not constitute the nature of the abusive conduct. Instead, it agency found the retroactive discounts of great concern, since they could make the effective price of a supplementary unit of product extremely low or even negative (and thus below any cost measure) – amounting to a targeted predatory practice. The requirement for consolidators to provide information on their clients to the dominant company was also a deep source of concern. Further evidence of abuse were: i) steep discounts (higher than in *La Poste*); ii) that any intermediary had to pre-finance any discount that it wished to pass down to its sender clients. Thus, also in this ruling it was not discrimination *per se* to be sanctioned as abusive.

As discussed above, pricing flexibility, whether vis à vis mailers or consolidators is a pivotal consideration in the key postal cases. Box 2 reviews the economic rationale behind it.

¹ bpost was also sanctioned for the same practice by the national regulator.

Box 2 The economic rationale for greater pricing flexibility

Postal services providers are multi-product firms with high fixed and common costs. Under these market features, economic theory states that Ramsey pricing is efficient. This is the setting of prices according to demand characteristics (instead of cost-oriented). Prices will be low for services with high price sensitivity and high for low price sensitivity services.

However, cost-orientation requirements for products within the USO constrain operators' ability to set prices reflecting differences in customers' demand characteristics. Non-cost-oriented pricing could increase efficiency and total welfare under certain circumstances, for instance if:

- (i) it allows postal operators to sell more than under cost-oriented prices; or
- (ii) customers with a low willingness to pay are able to acquire a product or service that they might be unaffordable at a cost-oriented price; or
- (iii) the postal operator's incentive to invest and to improve efficiency increases.

This is for example the case when price discrimination increases total mail volume (resulting in increased economies of scale) or when price discrimination makes a product available to mailers with relatively low willingness to pay.

Finally, Ramsey pricing leads to a price structure similar to that of a profit-maximising postal operator, but with a different level. While Ramsey pricing can be designed to ensure just the recovery of costs, a profit-maximising firm has incentives to increase prices beyond the cost-recovery level.

Source: Copenhagen Economics, *Pricing behaviour of postal operators* (2012), a report prepared for the European Commission, DG Internal Market and Services

Conclusions

Recent developments show a new orientation in case law: discrimination is not an abuse in itself. This has been an equally important consideration in both EC-level and national cases; and in cases where the discrimination is towards both mailers and consolidators. Instead than on discrimination *per se*, the focus is on whether prices (both the total price and the marginal price of the last unit) are above costs.

Implications for dominant firms: First, greater commercial freedom. When price discrimination is not a problem in itself, firms can charge different prices for different customers. However, the boundary to commercial freedom rests upon the pricing of each individual contract (whether standalone price or the result of a rebates schedule). A simple guidance could be:

	Retroactive (saw tooth) rebates, or generally price below average incremental cost, unless with a good explanation
	Price above average incremental cost, but below average total cost. Be aware if pricing is likely to force an efficient competitor out of the market.
	Price above total average cost

Besides pricing, other limits remain on commercial freedom. Review carefully whether your discounts are conditional on consolidators sharing information about their clients. Agencies could see this as a source of fidelity effects and thus evidence of abuse.

Implications for competitors: Be efficient and know your key competitor's costs. A simple set of guidelines for competitors could be:

- Be as efficient as the dominant firm.
- Proving elimination intent is hardly a viable strategy. It will either fail, because the competitor survived – or be too late, because competitors could not survive.
- Effective complaints require proving that the incumbent has priced below average incremental cost; thus, it is worthwhile to invest resources in estimating the incumbent's average incremental cost, in order to file an effective complaint and in order to know what is the incumbent's real room for manoeuvre .