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FOR A RIGOROUS "EFFECTS-BASED" ANALYSIS OF VERTICAL RESTRAINTS ADOPTED BY DOMINANT FIRMS:

AN ANALYSIS OF THE EU AND BRAZILIAN COMPETITION LAW

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June 2012

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TABLE OF CONTENT

I. Introduction 4

II. The economics of vertical restraints 8

A. The evolution of economic thinking with respect to vertical restraints 8

B. Pro-competitive vs. anti-competitive effects of vertical restraints 11

1. Exclusive dealing 11

2. Conditional rebates 12

3. Tying and bundling 14

III. From per se rules to effects-based analysis: Abuse of dominance in EU law 16

A. Brief introduction to EU competition law 17

B. Vertical restraints as exclusionary abuses: Review of the traditional case-law of the EU courts 17

C. From a form-based approach to effects-based approach to exclusionary abuses 18

1. The form-based approach pursued by the EU courts and the Commission 18

2. The application of a form-based approach to vertical restraints 19

3. The modernisation of the EU law of abuse of dominance and the 2005 Discussion Paper 25

4. The 2008 Guidance Paper 25

IV. Effects-based analysis with some twists: Abuse of dominance in Brazilian law 29

A. Brief introduction to Brazilian competition law 29

B. Vertical restraints as exclusionary abuses: Review of Brazilian Competition Law System’s Case-Law 31

1. Exclusive Dealing 31

2. Loyalty Rebates 35

3. Tying 37

C. An effects-based approach with some twists: the impact of vague terms in shifting standards of proof 39

V. Analytical framework for the application of competition rules to vertical restraints 43

A. Principles governing the assessment of vertical restraints 43

1. Vertical restraints should not be assessed under *per se* rules 43

2. The form and nature of a practice are not relevant to their assessment under competition rules: Only foreclosure effects matter 44

3. The "equally efficient" standard is the right standard of review 45

4. Consumer harm should be shown in that the anti-competitive effects of the restraints in question are not objectively justified or compensated by efficiencies 46

B. Application of the principles to vertical restraints 47

1. Exclusive dealing 48

2. Conditional rebates 50

3. Tying 62

VI. Necessary Institutional Background for Implementing the Proposed Analytic Framework 65

A. The EU Institutional Background 67

B. The Brazilian Institutional Background 70

VII. Conclusions 75

I. Executive summary

This study concerns the way agreements between a dominant supplier and its customers that restrict the ability of those customers to buy from the dominant firm's rivals, including exclusive dealing, conditional rebates and tying and bundling (hereafter, "vertical restraints") have been assessed by the EU and Brazilian competition authorities and courts.

For several decades, vertical restraints have been a subject of debate among lawyers and economists, and views as to how such restraints should be assessed have fluctuated. In recent years, however, a consensus has emerged that *per se* rules of illegality (or of legality) should not be applied to vertical restraints. Instead, such restraints should be assessed pursuant to an effects-based analysis balancing their pro- and anti-competitive effects. The difficulty, however, is to devise legal tests that allow this balancing to take place in a coherent and rigorous manner.

Following an analysis of the economics of vertical restraints, this paper shows that the European Commission, which has the power to enforce EU competition rules, has recently opted for an effects-based approach to vertical restraints, and has developed a Guidance Paper that offers a legal and economic methodology describing how it intends to analyse such restraints. This paper shows, however, that the EU courts are still reluctant to follow such a methodology preferring instead to continue to apply formalistic rules.

The situation is different in Brazil where, at least since the enactment of Law 8.884 in 1994, there has been a consensus that vertical restraints had to be analysed under an effects-based approach. However, such an approach has been pursued through balancing tests relying on qualitative criteria and intuitive reasoning, rather than and a rigorous and structured assessment, including quantitative elements, hence leading to inconsistency and uncertainty. The Brazilian competition law system would thus benefit from the adoption of guidelines, which as in the case of the EU Guidance Paper, provides a clear legal and economic methodology as to how an effects-based approach should be implemented.

This paper also analyses the extent to which the legal and institutional framework in place in the EU and in Brazil is well suited to the implementation of a rigorous effects-based approach relying on economic analysis. There is no doubt that the mature EU system possesses the legal and institutional framework to apply such a rigorous approach, the problem being however that the EU courts, which are composed of generalist judges, are still reluctant to pursue it. The European Commission, which is a sophisticated institution, can however pursue an economic based approach.

Although the Brazilian competition law system is not yet fully mature, it has gone a long way, and the entry into force of the new Brazilian Competition Act 12.529/2011 and the setting up of the New CADE will further contribute to its development. The paper argues that the Brazilian system would greatly benefit from the adoption of guidelines, which, like the European Commission Guidance Paper, would offer a clear legal and economic methodology to implement an effects-based approach to vertical restraints.

II. Introduction

This study concerns the assessment under competition rules of agreements between a dominant supplier and its customers that restrict the ability of those customers to buy from the dominant firm's rivals (hereafter, "vertical restraints"). These agreements include:

- Exclusive dealing whereby the dominant firm sells a product on the condition that buyers not buy that same product from its rivals.

- Conditional rebates, whereby the dominant firm offers price incentives to customers buying all or a high percentage of their purchases from it. Rebates may be made over a single product (single-product rebate) or several products (bundled rebate).

- Tying and bundling, whereby the dominant firm agrees to sell one product only on the condition that the buyer also takes a second product from that firm (tying) or where the dominant firm will only sell two products as a package (pure bundling).

While in the vast majority of cases these agreements are pro-competitive in that they are a source of efficiencies, there may be circumstances where they foreclose rivals and create consumer harm. For several decades, vertical restraints have been a subject of debate among lawyers and economists and views as to how such restraints should be assessed have fluctuated. In recent years, however, a consensus has emerged that *per se* rules of illegality (or of legality) should not be applied to vertical restraints. Instead, such restraints should be assessed pursuant to an effects-based analysis balancing their pro- and anti-competitive effects.

Against this background, the purpose of this study is to analyse the way competition authorities and courts should ideally assess vertical restraints in the light of modern economic thinking. In past decades, much has been written on vertical restraints and useful tools have been developed to help competition law enforcers in their difficult task of separating pro-competitive from anti-competitive restraints. Of course, there is no mathematical test that would allow competition authorities and courts to mechanically determine whether a given vertical restraint should be declared legal or illegal. While antitrust enforcement is not an exact science, it is nevertheless possible to develop tests relying on objective economic criteria and to establish safe harbours for conducts deemed legal. These tests and safe harbours allow competition enforcers to reduce the occurrence of errors (taking the form of over- or -under enforcement) and thus increase the credibility of their action.

This study will refer to the way vertical restraints have been treated under European Union (EU) and Brazilian competition law, particularly in the light of recent policy developments. There are four main reasons for this approach.

First, EU competition law is one of the two most influential competition law regimes in the world, the other being US antitrust law. While US antitrust law was a key source of inspiration for the early competition regimes, EU competition law is probably the most influential competition law regime in the 21th century for the following reasons: (i) it applies to the 27 EU Member States, which together represent close to 500 million consumers; (ii) the EU has

exported its competition law regime to other nations and trade blocks through bilateral and regional trade agreements;[1] and (iii) the EU regime is based on an administrative enforcement system which is generally easier to apply in foreign jurisdictions (in particular fast-growing economies) than the US litigation-based model, which requires a highly developed and well performing court system.[2]

Second, in the past decade, EU competition law went through a significant evolution moving away from a legalistic approach, based on *per se* rules, to an effects-based system relying on modern economic principles. Of course, not everything is perfect in the EU model. The EU courts (i.e., the General Court and the European Court of Justice) still tend to follow their formalistic case-law. In fact, the evolution comes from the European Commission, which in its Guidance Paper on Article 102 of the Treaty on the Functioning of the European Union (TFEU) clearly opts for a modern economic approach. That approach is of course not unique to the European Commission. US antitrust enforcement agencies and US courts led the way regarding the use of economic analysis in the assessment of vertical restraints, and a similar approach has now been adopted by the leading competition authorities around the world.[3]What makes EU law a particularly useful source of reference is that the policy shift of the European Commission is articulated in the Guidance Paper, which is a detailed, and well-articulated, policy document.

Third, as for Brazilian competition policy, it has developed at a fast pace during the last two decades, with improving enforcement capabilities and increasing analytical sophistication. Indeed, the Brazilian Competition Law System (BCLS)[4] has become a rising star among other developing jurisdictions, being praised for its "*strong institutional dedication to high standards of integrity, autonomy, sound policy, and fair procedure; an excellent leadership cadre; and a supportive business community*".[5] Moreover, considering the increasing relevance of its economy in global trade, Brazil has become an important jurisdiction for multinational companies, which generally take into account its competition policy when defining compliance programs.

Fourth, as many other developing jurisdictions, Brazil has been significantly influenced by EU competition policy. The Brazilian Competition Law System is also based on an administrative enforcement system, with deep European roots. In this sense, the comparative method offers a useful tool to illustrate how such influence may or may not generate close policy outcomes. In

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[1]See Damien Geradin, Competition Law and Regional Economic Integration: An Analysis of the Southern Mediterranean Countries (World Bank Working Papers), 2004, 106 pp.

[2]The Perils of Antitrust Proliferation: The Globalization of Antitrust and the Risks of Overregulation of Competitive Behavior, 10 (2009) Chicago Journal of International Law 189.

[3] See Einer Elhauge and Damien Geradin, Global Antitrust Law & Economics, 2nd Ed, Foundation Press, 2011.

[4]Under Competition Act 8.884/94, the Brazilian Competition Law System (BCLS) is composed by three authorities, namely Economic Monitoring Secretariat (SEAE), Economic Law Secretariat (SDE) and the Administrative Council For Economic Defense (CADE). The New Brazilian Competition Act 12.529/2011 will transfer all competition law matters to a new and more robust Administrative Council For Economic Defense (CADE) by June 2012. When referring to BCLS, this article means these authorities responsible for enforcement of competition policy in Brazil.

[5]OECD, *Brazil - Peer Review of Competition Law and Policy,* 2005, p. 102.

addition, the analysis of Brazilian case law and policy trends will probably present an interesting proxy of the tensions and challenges faced by other developing jurisdictions with the same roots, even though each competition law system will always have its own peculiarities.

This study is divided in six parts. Part II analyses the way economists have looked at vertical restraints over the past one hundred years. As will be seen, several schools of thought successively dominated the economic debate with each of them proposing radically different policy prescriptions (from the *per se* illegality of vertical restraints to their *per se* legality). Since the 1980s, there is, however, a broad consensus among economists that *per se* rules should not be applied to vertical restraints since their effects on competition depend on the circumstances of each case. Hence, such restraints should be subject to an effects-based analysis taking into account not only the potential anti-competitive effects of vertical restraints, but also the efficiencies they may generate. Part II then outlines the different categories of anti- and pro-competitive effects that can be generated by vertical restraints as identified in economic theory.

Part III discusses the way vertical restraints have been assessed under EU competition law and the new analytical approach adopted by the European Commission, which now assesses such restraints based on an effects-based analysis. Part III provides a brief introduction to EU competition law with a focus of Article 102 TFEU, which prohibits abuse of a dominant position. It then reviews the traditional case-law of the EU courts regarding vertical restraints, which is characterized by a strict approach towards vertical restraints. Finally, it discusses the reform of the enforcement of Article 102 TFEU the Commission embarked on in 2005[6] culminating with the adoption of its Guidance Paper on Article 102 in December 2008.[7]

Symmetrical to Part III described above, Part IV discusses the way vertical restraints have been assessed under Brazilian Competition Law. This Part provides an introduction to Brazilian Competition Law, with a brief overview of the Brazilian Competition Act 8.884/94 (BCA), as well as CADE's Resolution 20, which have been the ground rules for dealing with vertical restraints for the past 15 years. This introduction also makes reference to the new Brazilian Competition Act 12.529/2011 (NBCA), which does not substantially change these basic rules. Finally, this part provides an overview of the recent Brazilian case-law, which generally follows an effects-based approach, but sometimes still comes close to a strict approach.

Drawing from the experiences of EU and Brazil, Part V seeks to provide some bright lines for the enforcement of competition rules in the field of vertical restraints. In light of the Guidance Paper produced by the EU Commission, which provides a well-articulated policy towards

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[6] NeelieKroes, "Preliminary Thoughts on Policy Review of Article 82", Speech at the Fordham Corporate Law Institute New York, 23 September 2005.

[7] Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings issued in December 2008, [2009] OJ C45/7. Generally, on the Guidance Paper, see Is the Guidance Paper on the Commission's Enforcement Priorities in Applying Article 102 TFEU to Abusive Exclusionary Conduct Useful? in F. Etro and I. Kokkoris, Eds,Challenges in the Enforcement of Article 102, by Oxford University Press, 2010.

vertical restraints, Part V first provides a set of sound legal and economic principles that should be used to analyse vertical restraints adopted by dominant firms. It then applies these principles to the assessment of the various categories of vertical restraints analysed in this paper (i.e. exclusive dealing, rebates and tying) with specific references to the European Commission's Guidance Paper on Article 102 and some references to Brazilian case law.

Part VI discusses the institutional environment that is needed to implement the analytical framework proposed in Part V. In particular, we discuss five different institutional elements: (i) legislation; (ii) regulations containing guidelines to implement the legislation; (iii) the authorities' capability to develop sound economic analysis of vertical restraints; (iv) the courts' readiness to review this type of analysis; and (v) the ability of the antitrust community (i.e., in-house counsel, external counsel and economic consultants) to deal with this type of analysis. Finally, Part VII contains a short conclusion.

III. The economics of vertical restraints

This Part first discusses the evolution of economic thinking regarding vertical restraints over time. It then discusses the possible anti- and pro-competitive effects of such restraints.

A. The evolution of economic thinking with respect to vertical restraints

For a long time, competition authorities and courts dealing with vertical restraints tended to favor the application of simple standards whereby certain types of restraints were *per se* illegal, i.e. they were banned independently of the demonstrated presence of anti-competitive effects and consumer harm. In the 1950s and 1960s, economists at the University of Chicago (the so-called "Chicago School") started to challenge such a formalistic approach by introducing analytical rigor into the analysis of vertical restraints.[8] Their approach, which effectively led to a minimal enforcement of antitrust rules, was, however, challenged in the 1980s by other economists (the "Post-Chicago School") who argued that firms' incentives and behavior were more complex than depicted by the Chicago School and that greater attention had to be paid to the "strategic behaviors" of firms affecting market performance.[9]

Tying offers a nice illustration of the way economic thinking over vertical restraints has evolved over the past decades. The central idea behind the anti-competitive tying theories is that a dominant firm can use the market power it holds in its primary monopoly market to extend (leverage) it into another, related market by tying the purchase of the two products together. Because customers must obtain the monopoly product from the dominant firm (e.g., a photocopy machine with no rival in its category), if that firm ties a complementary product (e.g., ink

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[8] This school was composed of antitrust experts, including Aaron Director, Robert Bork, Frank Easterbrook and Richard Posner. For an excellent overview of the Chicago School position on antitrust, see Robert Bork, The Antitrust Paradox - A Policy at war with Itself, The Free Press, 1978, New Edition, 1993.

[9] See Herbert Hovenkamp, "Post-Chicago Antitrust: A Review and Critique", 2001 Columbia Business Law Review 257.

cartridges) to its monopoly product, then customers will be less willing to purchase a separate tied product from a rival supplier, thereby foreclosing competition in the otherwise competitive complementary market.

In the first part of the 20thcentury, economists simply assumed that by tying a second product to the purchase of its monopoly product, a dominant supplier could earn two monopoly profits instead of one. Under this view, tying was clearly anticompetitive and exclusionary, motivated solely by the dominant firm's desire to increase its profits. Hence, tying was treated as *per se* illegal because its only perceived purpose was to extend a monopoly into nearby complementary markets. This view strongly influenced the initial legal treatment of vertical restraints with the US Supreme Court notably declaring in an often cited dictum that "[t]ying serves hardly any purpose beyond the suppression of competition."[10]

In the 1950s, economists at the University of Chicago, such as Robert Bork or Richard Posner, challenged that logic. Relying on theoretical models that provided a framework for thinking about firm incentives and behaviour, Chicago School economists argued that once a dominant firm had extracted the monopoly rents from a particular market, it could not earn additional monopoly profits through a related complementary market (an insight usually referred to as the "single monopoly profit" theorem).[11]Their classic example was a monopolist in nuts who tried to tie nuts to bolts.[12] Chicago School economists showed that if the firm holding a monopoly in nuts was already pricing its nuts at the monopoly level, it could not earn more by tying the purchase of nuts to the purchase of bolts. Hence, if there is one monopoly profit to earn from a bundle of complementary goods, dominant firms have no anticompetitive incentive to tie complementary products.

Chicago School scholars also argued that, under the single monopoly profit theorem, dominant firms may even have an incentive to encourage competition in markets that are complementary to their monopoly market.[13] For the Chicago School, any tying practiced by a dominant firm must thus be motivated by efficiency reasons since, as will be seen below, there are often good reasons why a dominant firm may wish to sell products together.[14]The Chicago School analysis therefore implies that tying arrangements should be treated under a *per se* rule of legality in direct contrast with the *per se* rule of illegality that was promoted in the prior regime.

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[10] *Standard Oil Co. of Cal. v. United States (Standard Stations)*, 337 U.S. 293, 305-06 (1949).

[11] See e.g., Robert Bork, "Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception," (1954) 22 *The University of Chicago Law Review*, 157, 196; Robert Bork, *The Antitrust Paradox*, The Free Press: New York, (1978) at 372-375, 380-381; Richard Posner, "The Chicago School of Antitrust Analysis," (1979) 127 *University of Pennsylvania Law Review,* 925; Richard Posner, *Antitrust Law: An Economic Perspective*, University of Chicago Press, (2001), at 198-199.

[12] See Elhauge and Geradin, supra note 3, at 562.

[13] Id.

[14] For a discussion of the pro-competitive, efficiency-based justifications of tying, see David S. Evans and Michael Salinger, "Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law", (2002) 22 Yale Journal on Regulation 37.

In the beginning in the 1980s, however, the Post-Chicago School, identified several important limitations to the single monopoly profit theorem. Post-Chicago scholars pointed out the important assumptions (implicit and explicit) that underpin the Chicago School theory and the implications of relaxing those assumptions. For instance, one of the more pivotal assumptions behind the single monopoly profit theorem is that the monopoly good and the complementary tied good are used in fixed proportions (which is typically the case for nuts and bolts).[15]However, many complementary products are not used in fixed proportions. For instance, game consoles may be sold with some games, but users will typically buy many more games (hence, making game sales particularly profitable). Variable proportion inputs therefore make it possible for a dominant firm to increase its profits by expanding its dominance into the complementary market. Another critical assumption of the single monopoly profit theorem is that the complementary market is characterised by perfect competition and constant economies of scale. But, again, this is not always the case.

Against that background Post-Chicago School economists have shown monopoly leveraging through tying could be a profitable anticompetitive strategy for dominant firms. It is important, however, to note that just like the Chicago School models, the Post-Chicago models rest on some strong assumptions and therefore can only be applied to policy with great caution, something that the authors themselves have been quick to point out.[16] Moreover, these models may often be difficult to implement in practice.[17]

Conclusion. The evolution of economic thinking over tying shows that different economic schools perceived tying in radically different ways and made radically different policy prescriptions (from *per se* illegality to *per se* legality). The position of most economists today is a moderate one, lying in between the two *per se* extremes of earlier years. A comparable evolution can be observed in other types of vertical restraints (e.g. exclusive dealing and conditional rebates) where economists generally consider that such restraints should not be subject to *per se* rules, but on the contrary to some form of rule of reason, or in EU parlance "effects-based" analysis.

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[15] See Michael Whinston, "Tying, Foreclosure, and Exclusion", (1990) 80 American Economic Review 837.

[16] See, e.g., Dennis W. Carlton & Michael Waldman, *Theories of Tying and Implications for Antitrust*, in W. Dale Collins (ed.) Economics of Antitrust (American Bar Association - forthcoming). Hart et al. concede a similar point in their seminal paper on vertical integration simply stating that "Given these conflicting effects it is hard to deliver clear-cut prescriptions for antitrust policy on vertical mergers." Oliver Hart et al., "Vertical Integration and Market Foreclosure", (1990) 1990 *Brookings Papers on Economic Activity. Microeconomics*, 205, 213.

[17] Herbert Hovenkamp made this point in his general critique of the post-Chicago school noting that, "[w]hile [the post-Chicago methodologies] sometimes produce robust economic conclusions, testing them has proven difficult. Further, they are messier and more difficult to use and too often strain the fact-finding power of courts beyond the breaking point." Herbert Hovenkamp, supra note 9, at 336.

B. Pro-competitive vs. anti-competitive effects of vertical restraints

As noted in the preceding section, current economic thinking suggests that while vertical restraints may produce exclusionary effects, the harm to competition created by such restraints can generally be more than compensated by the presence of efficiencies. In this section, we thus review the potential anti- and pro-competitive effects of vertical restraints.

1. Exclusive dealing

1.1 Possible anti-competitive effects

The major anti-competitive concern raised by exclusive dealing agreements is that such agreements might foreclose enough of the market to competitors to impair competition.[18] Such foreclosure may impede entry or expansion of rivals in the market, or accelerate their exit from the market, hence increasing the market power of the excluding firm.

First, most industries are subject to economies of scale, meaning that firms can lower their costs by expanding until they reach the output level that minimizes their costs, which is called the minimum efficient scale.[19]If foreclosure prevents a competitive number of rivals from maintaining this scale, or from expanding their operations to reach it, then it impairs their efficiency. Second, foreclosure can similarly deprive rivals of economies of scope if, without the foreclosure, rival expansion would have enabled them to offer a variety of products that can be more efficiently produced or sold together than separately. Third, most industries are characterized by a learning curve, so that substantial foreclosure of the market can impair rivals efficiency by simply slowing down that expansion even though foreclosure does not outright prevent that expansion.[20]

If rival efficiency is impaired in any of these ways, then rivals will have to cover their now-higher costs by charging higher prices than they otherwise would have. In the extreme case, these higher prices will be unsustainable, and thus rival entry will be deterred and existing rivals will be eliminated. But even if foreclosure reduced rival efficiency without outright eliminating them, it will worsen the market options available to consumers, and mean that these rivals will impose less of a constraint on the defendant's market power than they otherwise would have. This can thus enhance or maintain that market power even if it does not drive rivals from the market bar their entry.

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[18] See Elhauge and Geradin, supra note 3, at 516.

[19] Id.

[20]Note that even if rivals are able to achieve their minimum efficient scale and scope of production, foreclosure that bars rivals from the most efficient means of distribution (downstream exclusive dealing) can also impair rival efficiency by increasing their costs. Conversely, dominant firms may foreclose rivals by denying them access to key inputs by making exclusive deals with the sellers (upstream exclusive dealing).

1.2 Possible redeeming efficiencies

Although exclusive dealing agreements can have anticompetitive effects, they also have many possible redeeming efficiencies.[21]For instance, exclusive dealing obligations are often used to reduce uncertainty about whether future sales will occur at the contractually set price. Such obligations can give suppliers the contractual commitments they need to be able to invest in capital intensive projects (e.g., banks may only agree to fund the construction of a power plant if they have guarantees that the owner of the plant will be able to sell its power to a number of key customers). Relatedly, exclusive dealing might encourage the supplier to make a relation-specific investment (such as building a production plant in the vicinities of a given customer).[22]Short of such commitment, the supplier would take the risk to be left with unproductive assets that, because they are relation-specific, cannot be redeployed to supply other buyers. Finally, exclusive dealing is regarded as an important remedy to prevent free riding, whenever specific investment in services and reputation is required (e.g. the investment made by a distributor in training personnel and offering high level of services may be important to build brand reputation for a particular supplier and, without exclusivity, other distributors might capture part of the gains associated with such reputation, thereby reducing the incentives to invest in such services)[23].

2. Conditional rebates

Although there are many definitions of conditional rebates, this paper considers such rebates as covering different incentive schemes granted by a supplier to its customers or distributors/retailers *provided* that their purchases or sales achieve or exceed certain thresholds formulated in terms of volume targets, percentages of total requirements or increase in purchases.[24]

Conditional rebates can be classified into different categories. For instance, Ahlborn and Bailey distinguish rebates, according to:

- The *type of thresholds* which can be defined in terms of volume targets (quantity rebates) or percentage of total requirements (market-share rebates) or increase in

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[21]Id. at 519.

[22] Id.

[23] Jonathan M. Jacobson, "Exclusive Dealing, 'Foreclosure,' and Consumer Harm", 70 *Antitrust Law Journal* 311 (2002), at 321: "*Exclusive dealing arrangements generally promote more effective distribution by increasing dedication and loyalty; and they can minimize free-riding, improve product quality, and ensure customers and suppliers of a reliable source of supply*".

[24] This definition draws on GianlucaFaella, "The Antitrust Assessment of Conditional Discounts and Rebates", 4 *Journal of Competition Law and Economics* 375 (2008), at 376. See also the definition given by the Commission in its *Guidance Paper*, supra note 7, at § 13 ("Conditional rebates are rebates granted to customers to reward them for a particular form of purchasing behaviour.")

purchases (growth rebates). When the percentage required is 100%, we can speak of exclusive rebates;

- The *scope of application*, whether they are forward-looking, i.e. they apply to incremental units above the threshold (incremental rebates) or backward looking, i.e. applying to both units below and above the threshold (retroactive rebates or roll-back rebates);

- The *products or set of products to which they apply*, whether they apply to one category of products (single product rebates) or across several distinct products (multi-product or bundled rebates).[25]

This paper will classify rebates according to the way they operate and their potential effects on competition. It distinguishes between *single-product* and *multi-product* (bundled) rebates.

2.1 Possible anti-competitive effects

The anti-competitive concern raised by conditional rebates are essentially similar to those raised by exclusive dealing given that such rebates are essentially a less absolute form of exclusive dealing (since they give buyers a choice between complying with the condition attached to the rebate or foregoing the rebate). The concern is thus that when they tie a sufficiently large share of the market conditional rebates may lead to foreclosure of rivals. Conditional rebates may thus be used by dominant firms to prevent entry or expansion of rivals, or force them to exit the market when they are unable to match the dominant firm's rebates while remaining profitable.

2.2 Possible redeeming efficiencies

Conditional rebates may allow suppliers and customers to achieve a variety of efficiencies, which explain why they are used by both dominant and non-dominant firms. Such efficiencies include:

Price reduction. The most obvious effect of rebates is to reduce the prices of the firm offering the rebate to the direct benefit of its customers.[26] This also stimulates price cuts by other competitors which in turn enable firms on downstream markets to decrease their prices to their own customers.

Economies of scale and faster fixed costs recovery. In industries with high fixed costs, such as for instance innovative industries (information technology, pharmaceuticals, etc.) or large utilities (telecommunications, energy, etc.), rebates allow suppliers to increase output and, in

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[25] Christian Ahlborn and David Bailey, "Discounts and Selective Pricing by Dominant Firms: A Trans-Atlantic Comparison", 2 *European Competition Journal* (2006) 101, 1004.

[26] This is true unless, of course, the grant of discounts is accompanied by an increase of initial prices (the so-called "penalty prices").

turn, recover their fixed costs more rapidly (since they will be able to achieve economies of scale by spreading their fixed costs over larger volumes) resulting in lower average total costs and prices for consumers.[27]

Economies of scope and reduction of transaction costs. Multi-product rebates can allow businesses to achieve economies of scope and reduce transaction costs as buyers are able to obtain the requirements for different products from a single supplier.[28]

Avoiding double marginalization. Rebates assist in avoiding "double marginalization" as, if the dominant firm's customer also enjoys substantial market power, there is a risk that absent the rebates, the price would be higher than the price which would prevail if a vertically-integrated monopolist was operating on the market.[29]

Preventing hold-up. In certain cases, the rebate system may be necessary to provide the incentive for the dominant supplier to make certain relationship-specific investments to supply a particular customer.[30] This may be the case when supplying a customer requires the supplier to invest in new technologies, new production or even build a production plant. Conditional rebates may be the most efficient way to give the type of assurances needed by the supplier to engage in such investments.

Supplementary services. Rebates may also be an effective way of providing incentives for customers to supply complementary services (product promotion, etc.), hence aligning the incentives of the customers with those of the supplier.[31]

3. Tying and bundling

Tying is a common practice used by both dominant and non-dominant firms to offer better, cheaper and more convenient products or services. Shoes have always been sold with laces and cars with tires, and hotel nights generally with breakfast. But beyond these trivial examples, product integration has become a key business strategy in many industries. Manufacturers of consumer electronics, for instance, combine many different components into a single product to make these components work better or to make the product more cost-effective, smaller and

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[27] See Derek Ridyard, "Exclusionary Pricing and Price Discrimination Abuses under Article 82 – An Economic Analysis", (2002) 6 *European Competition Law Review*, 286.

[28] See United States, Roundtable on Bundled and Conditional Discounts and Rebates; DAF/COMP/WP3/WD(2008)47, at § 8.

[29] See Simon Bishop, "Delivering Benefits to Consumers or Per Se Illegal? Assessing the Competitive Effects of Conditional Rebates" in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, 2005, at 73. See also Kolay, S., G. Shaffer, and J. Ordover. 2004. "All Units Discounts in Retail Contracts". *Journal of Economics & Management Strategy*, Vol. 13 (3): 429-459.

[30] See European Commission, European Commission, Roundtable on Bundled and Conditional Discounts and Rebates; DAF/COMP/WP3/WD(2008)48, at § 26.

[31] See Bishop, supra note 29, at 72.

consuming less energy. Smartphones, for instance, comprise elements that used to be provided separately (phone and camera, for instance), and their larger screen allows users to play games, exchange emails, browse the Internet and access various forms of online content. Manufacturers seek to grow sales by increasing the value proposition offered to their customers and tying different functionalities is an important part of that strategy.

3.1 Possible anti-competitive effects

While in the vast majority of cases tying is pro-competitive, tying may also be used as an exclusionary strategy. First, there may be circumstances where a firm that is dominant in the market for the tying product may seek to extend its market power into the market for the tied product by tying the purchase of the two goods together (a strategy often referred to as "monopoly leveraging").[32] Because customers must obtain the monopoly product from the dominant firm, if that firm ties a complementary product to its monopoly product (that is, customers can only buy the monopoly product if they also purchase the tied product), then customers will be less willing to purchase a separate (now redundant) tied product from an independent supplier, thereby foreclosing competition in the otherwise competitive complementary product market.

Second, there may also be circumstances where tying may not be so much about leveraging a dominant position in the tying product market to the tied product market as it is about protecting dominance in the tying product market.[33] When the tying monopolist has reason to believe that successful tied product makers are likely to evolve into tying product makers in the future, it has incentives to foreclose rivals in the tied product markets to prevent or reduce erosion in its tying market over time. For instance, in the US Microsoft case, the Department of Justice (DoJ) argued that by tying Windows with Internet Explorer, Microsoft did not aim to reap profit in the browser market, but protect its dominant position in the operating system market from the threat that might emerge from a significant browser competitor, which could eventually be turned into an alternative operating system.[34]

3.2 Possible redeeming efficiencies

Tying and bundling can be the source of efficiencies we discuss hereafter.

Increasing the value of products to users. Two products may be more valuable to users when tied together. Buyers may, for instance, give greater value to a mobile phone that also contains a camera and an MP3 player, or an automatic washing machine that also dries clothes. Buyers may

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[32] See Einer Elhauge and Damien Geradin, 3, at p. 495 et seq.

[33] See, e.g., R. Cooper Feldman, "Defensive Leveraging Strategy in Antitrust", (1999) 87 Georgetown Law Journal, 2079.

[34] Timothy Bresnahan, Network Effects and Microsoft, SIEPR Discussion Paper No. 00-51, August 2001, available at http://www-siepr.stanford.edu/papers/pdf/00-51.pdf

thus be willing to offer a price premium for products conveniently integrating complementary features.

Economies of scale in production and distribution. In certain circumstances, tying may give rise to savings in production costs.[35] For instance, Evans and Salinger have shown that the costs of producing tablets that contained both pain reliever medicine and decongestant are much lower than the combined costs of production of separately branded tablets.[36] Combining different products may also reduce distribution costs. For instance, shipping a PC together with a series of complementary items, such as a keyboard, a mouse, and a monitor certainly saves transport, packaging and invoicing costs. Similar savings can be achieved by combining MP3 players and earphones, and cameras with lens cover, flash equipment, batteries and chargers.

*Brand protection and product safety.*In certain circumstances, the sellers of the tying product might require that buyers use its tied product with it because they are concerned that buyers will otherwise use an inferior substitute that will make the tying product work less well and lower its brand reputation.[37]For example, a fast food franchisor might sell its franchise (the tying product) to the franchisees who own the individual fast food restaurants on the condition that the franchisees buy their meat (the tied product) exclusively from the franchisor. Manufacturers may also engage in tying to address safety concerns. Producers of disposable razors may, for instance, be concerned about the quality of the blades produced by others and thus decide to tie their razors with blades. Note that in these examples a less restrictive alternative might be simply to inform buyers about the quality issue.[38]

IV. From per se rules to effects-based analysis: Abuse of dominance in EU law

As observed in Part II, the way economists have analyzed vertical restraints has considerably evolved over the years to now reach a moderate position where most economists agree that, while they can be a source of efficiencies, there may be situations where such restraints create foreclosure effects.

The position of competition authorities and courts on vertical restraints has also evolved over the years, not necessarily at the same speed, however, as economic thinking. For a long period of time authorities and courts generally took a strict approach to vertical restraints adopted by dominant firms holding them *per se* illegal. However, times have changed and authorities and courts have been more open to engage in a “rule or reason” or “effects-based” analysis of vertical restraints.

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[35] See Robert O’Donoghue and Jorge Padilla, The Law and Economics of Article 82 EC, Hart Publishing, 2006, at 481.

[36] Michael Salinger and David Evans, Curing Sinus Headaches and Tying Law, An Empirical Analysis of Bundling Decongestants and Pail Relievers, CESIFO WORKING PAPER NO. 1519, August 2005, available at http://www.econstor.eu/bitstream/10419/18983/1/cesifo1_wp1519.pdf

[37] See Elhauge and Geradin, supra note 3, at 570.

[38] Id.

In order to illustrate this evolution, this Part of the paper focuses on the way vertical restraints adopted by dominant firms have been assessed under EU competition law. In order to address criticisms from scholars and practitioners that its approach to exclusive dealing, rebates, tying, and other potentially exclusionary measures, was overly restrictive and not in line with modern economic thinking, the Commission embarked on a reform that culminated with the adoption of its Guidance Paper on the enforcement of Article 102 TFEU (hereafter, the "Guidance Paper").[39]

Against this background, this Part will be divided into three sections. Section A provides a brief introduction to EU competition law with a focus of Article 102 TFEU, which prohibits abuse of a dominant position. Section B reviews the traditional case-law of the EU courts regarding vertical restraints, which is characterized by a strict approach towards vertical restraints. Section C discusses the Commission's reform of its enforcement of Article 102 TFEU, which is designed to place it in line with modern economic theory.

A. Brief introduction to EU competition law

EU competition law came into existence with the adoption of the Treaty of Rome (also known as "EC Treaty" and now, following successive modifications, referred to as the "Treaty on the Functioning of the European Union" or "TFEU") in 1957, which contained several competition law provisions. The main provisions are Article 101, which prohibits anti-competitive agreements between firms, and Article 102, which prohibits dominant firms from abusing their dominant position. While vertical restraints can fall within the scope of Article 101 (in the absence of a dominant firm) and Article 102 (in the presence of a dominant firm), this paper focuses on the application of the latter provision. The most relevant case-law in the field of vertical restraints is indeed based on Article 102.

The main enforcement body is the European Commission (although national competition authorities may also enforce EU competition rules), which can adopt infringement decisions, as well as impose remedies and fines.[40] Commission decisions can be appealed at the General Court (which is based in Luxemburg) and General Court decisions can be appealed at the European Court of Justice (also based in Luxemburg), which is the jurisdiction of last resort. In addition to binding decisions, the Commission can also issue policy documents, such as guidelines, notices or, as illustrated with respect to Article 102 TFEU, even more informal Guidance.

B. Vertical restraints as exclusionary abuses: Review of the traditional case-law of the EU courts

Anti-competitive vertical restraints adopted by dominant firms are typically considered as "exclusionary" abuses in that they "foreclose" rivals. Competition authorities and courts around

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[39] See supra note 7.

[40] Regulation No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, O.J. 2003, L 1/1.

the world have faced considerable difficulties in developing standards that would allow them to distinguish anticompetitive foreclosure from competition on the merits. This led to the frustration of some scholars. As far as US law is concerned, Einer Elhauge argued in 2003 that "for decades monopolization doctrine ha[d] been governed by standards that are not just vague but vacuous."[41]Referring to the case law of the EU courts, Temple Lang and O'Donoghue, for instance, similarly stated in 2005 that "no currently-applied definition [of exclusionary abuse] has sufficient normative content to be applied ex ante as a normative rule by firms making pricing decisions or embarking on a given course of conduct."[42]

In fact, these authors complain about the application of standards based on vague concepts, such as that exclusionary abuses would amount to adopting "methods different from those which condition normal competition in products or services",[43] behaviour that is not "competition on the merits", or not in compliance with the "special responsibility" that dominant firms hold vis-à-vis their smaller rivals.[44] Reliance to such vague concepts was one of the reasons that led the Commission to adopt its Guidance Paper on Article 102, which, as will be seen below, contains a much more robust definition of exclusionary abuses. The other reason for the issuance of this Guidance Paper was the excessively strict and formalistic approach followed by the Commission and the EU courts in their application of Article 102 to exclusionary abuses to which we turn in the next section.

C. From a form-based approach to effects-based approach to exclusionary abuses

1. The form-based approach pursued by the EU courts and the Commission

For the past two decades, a recurring criticism of the decisional practice of the Commission and the case law of the EU courts on exclusionary abuses (including anti-competitive vertical restraints) was that they were not in line with modern economic thinking. The reasons were that (i) cases were often decided on "formal" considerations, such as the nature of a given conduct, rather than its effects on competition and consumer welfare and (ii) that the efficiencies that can be generated by dominant firm conduct were not taken into consideration at all or insufficiently so. That led to a case law that was highly unfavourable to dominant firms, which in some cases failed to engage in pro-competitive conduct by fear that such conduct may fall foul of Article 102.

As will be seen below, vertical restraints adopted by dominant firms were treated particularly strictly by the Commission and EU courts, although some of the more recent cases signalled a positive evolution.

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[41]EinerElhauge, *Defining Better Monopolization Standards*, 56 Stanford Law Review 253 (2003).

[42] J. Temple Lang and R. O'Donoghue, "The Concept of Exclusionary Abuse under Article 82", *GCLC Research Papers on Article 82*, July 2005, mimeo.

[43] Case 85/76 Hoffman-La Roche v Commission [1979] ECR 461, paragraph 91

[44]Case 322/81, Michelin v. Commission [1983] ECR 3461, para. 57

2. The application of a form-based approach to vertical restraints

2.1 Exclusive dealing

The Commission and the EU courts have traditionally taken a strict approach to exclusive dealing. In *Hoffman-La Roche*, the leading global producers of vitamins, Roche, had concluded with 22 large purchasers of vitamins sale contracts under which these purchasers undertook to obtain all or most of their requirements of vitamins or certain vitamins exclusively from Roche or which gave them an incentive to do so by including a promise of a discount (see section __ below).[45] The Commission found that these contracts breached Article 102 TFEU. On appeal, ECJ supported the Commission decision stating that:

> "An undertaking which is in a dominant position on a market and ties purchasers -- even if it does so at their request -- by an obligation or promise on their part to obtain all or most of their requirements exclusively from the said undertaking abuses its dominant position within the meaning of Article [102 TFEU], whether the obligation in question is stipulated without further qualification or whether it is undertaken in consideration of the grant of a rebate."[46]

The ECJ thus took a quasi *per se* illegality approach vis-à-vis exclusive dealing obligations in that it does not find it necessary to analyse the effects of such obligations on the market in question. This strict position was confirmed later in the judgment where the ECJ states that the concept of an abuse "in principle includes any obligation to obtain supplies exclusively from an undertaking in a dominant position which benefits that undertaking."[47]

In *Van den Bergh Foods*, the Commission and General Court, however, seem to have taken a more flexible approach to exclusive dealing obligations. Van den Bergh Foods, the dominant producer of single-wrapped ice creams for immediate consumption (referred to in the case as "impulse ice-creams"), had for a number of years supplied free of charge ice-cream retailers with freezer cabinets provided that they would be used exclusively for its ice creams. Around 40% of the available outlets were tied up by such an exclusivity obligation. The Commission found Van den Bergh Foods' conduct in breach of Article 102.[48] In its decision, it nevertheless specified that:

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[45]Case 85/76 Hoffman-La Roche v Commission [1979] ECR 461.

[46]Id. at § 89.

[47]Id. at § 121.

[48]Decision 98/531/EC, Van den Bergh Foods, 1998 O.J., L 246/1.

> "for the purpose of applying Article [102 TFEU], the circumstances surrounding the agreements and particularly their effect on the structure of competition in the relevant market must be taken into account in establishing the existence of an abuse."[49]

On appeal, the General Court supported the Commission decision and stated that:

> "The fact that an undertaking in a dominant position on a market ties de facto ─ even at their own request ─ 40% of outlets in the relevant market by an exclusivity clause which in reality creates outlet exclusivity constitutes an abuse of a dominant position within the meaning of Article [102 TFEU]. The exclusivity clause has the effect of preventing the retailers concerned from selling other brands of ice cream (or of reducing the opportunity for them to do so), even though there is a demand for such brands, and of preventing competing manufacturers from gaining access to the relevant market."[50]

The above extracts suggest that the Commission and the General Court consider that an analysis of the "effects" of an exclusive dealing obligation should be part of the assessment of the compatibility of such an obligation with Article 102 TFEU.

2.2 Conditional rebates

Hoffman-La Roche was the first major judgment of the ECJ dealing with rebates. As seen in the preceding section, Roche had concluded exclusive dealing obligations with 22 large purchasers of vitamins. For some of the contracts at stake, Roche also paid a rebate to those customers who had obtained all or most of their requirements from Roche calculated on vitamin total purchases. The amount of the rebate differed from customer to customer and typically varied between 1% and 5%, although one customer received rebates of 12.5% to 20%.

In its judgment, the ECJ took vis-à-vis the rebates in question a position identical to the one it had applied for Roche's exclusive dealing obligations. It stated that a dominant undertaking was also in breach of Article 102 TFEU:

> "if the said undertaking, without tying the purchasers by a formal obligation, applies, either under the terms of agreements concluded with these purchasers or unilaterally, a system of fidelity rebates, that is to say discounts conditional on the customer's obtaining all or most of its requirements — whether the quantity of its purchases be large or small — from the undertaking in a dominant position."[51]

The ECJ considered that such rebates were incompatible with the objective of undistorted competition within the common market, because "they are not based on an economic transaction

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[49]Id. at § 268.

[50]Case T-65/98 Van den Bergh Foods Ltd v Commission [2003] ECR II-4653, at § 160.

[51]*Hoffmann-La Roche* supra note 45, at § 89.

which justifies this burden or benefit but are designed to deprive the purchaser of or restrict his possible choices of sources of supply and to deny other producers access to the market."[52] The ECJ also established a distinction between "fidelity" rebates and "volume" rebates by stating that "the fidelity rebate, unlike quantity rebates exclusively linked with the volume of purchases from the producer concerned, is designed through the grant of a financial advantage to prevent customers from obtaining their supplies from competing producers."[53]

In *Hoffman-La Roche*, the ECJ thus took a particularly strict position vis-à-vis rebates adopted by dominant firms:

- It adopted a *per se* rule of illegality against so-called "fidelity" rebates in exchange of which buyers commit to buy all or a large percentage of their requirement from the dominant supplier.[54]

- "Volume" rebates are similarly in breach of Article 102, except when the rebate amounts to the cost savings a dominant firm is able to realize by selling larger volumes to buyers.

- The ECJ does not analyse the effects of the rebates granted by the dominant firm on competition and consumer welfare.

The ECJ adopted a few additional judgments dealing with rebates in which it found that:

- Rebates with long reference periods (e.g., one year) are more likely to be anti-competitive than rebates with short reference periods (e.g., three months).[55]

- Rebate regimes that are opaque (because the terms and conditions of the rebates are not clear) are more likely to be anti-competitive than transparent rebate regimes.[56]

- "Retroactive" rebates, i.e. which even if they only kick in after a certain volume is purchased "roll back" to the first unit purchased, are anti-competitive.[57]

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[52]Id. at § 90.

[53] Id.

[54]Case 322/81, *NV NederlandscheBandenIndustrie Michelin v Commission (Michelin I)*, [1983] ECR 3461 at § 14.

[55]Id. at § 81.

[56]Id. at § 83.

[57]Id. at § 81. See also Michelin II in which the GC observed that "if a discount is granted for purchases made during a reference period, the loyalty-inducing effect is less significant where the additional discount applies only to the quantities exceeding a certain threshold than where the discount applies to total turnover achieved during the reference period. In the latter case, the saving which may be made by reaching a higher scale applies to total turnover achieved whereas, in the former case, it applies only to the additional amount purchased." GC, *Manufacture française des pneumatiquesMichelin v. Commission (Michelin II)*, T-203/01, [2003]ECR II-4071 at § 85.

Some scholars have, however, observed that, contrary to a commonly held belief, the ECJ does not apply a *per se* illegality rule to rebates granted by dominant firms as it suggested in some cases that the effects of the rebates had to be taken into account and that it was willing to consider objective justification. For instance, in *British Airways,*[58] stated that:

> "[It] first has to be determined whether those discounts or bonuses can produce an exclusionary effect, that is to say whether they are capable, first, of making market entry very difficult or impossible for competitors of the undertaking in a dominant position and, secondly, of making it more difficult or impossible for its co-contractors to choose between various sources of supply or commercial partners.
>
> [...] It then needs to be examined whether there is an objective economic justification for the discounts and bonuses granted […]. [A]n undertaking is at liberty to demonstrate that its bonus system producing an exclusionary effect is economically justified.
>
> [...] Assessment of the economic justification for a system of discounts or bonuses established by an undertaking in a dominant position is to be made on the basis of the whole of the circumstances of the case. [...] It has to be determined whether the exclusionary effect arising from such a system, which is disadvantageous for competition, may be counterbalanced, or outweighed, by advantages in terms of efficiency which also benefit the consumer. If the exclusionary effect of that system bears no relation to advantages for the market and consumers, or if it goes beyond what is necessary in order to attain those advantages, that system must be regarded as an abuse."[59] (emphasis added)

Although the EU courts have never struck down any infringement decision of the Commission prohibiting rebates, the above extract suggests that these courts are at least willing to contemplate the justifications that could be offered by the dominant firm to justify its rebates.

2.3 Tying

The Commission has only issued a small number of decisions concerning tying and bundling, the most famous one being its 2004 decision in which it decided that Microsoft infringed Article 102 by tying Windows Media Player (WMP) with its Windows PC operating system (Windows).[60] The Commission considered that anti-competitive tying requires the presence of the following elements: (i) the tying and the tied goods are two separate products; (ii) the undertaking concerned is dominant in the tying product market; (iii) the undertaking concerned does not give

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[58]Case T-219/99, *British Airways plc v Commission*, [2003] ECR II-5917 and Case C-95/04 P, *British Airways plc v Commission*, [2007] ECR I-2331.

[59] Case C-95/04 P, *British Airways plc v Commission*, [2007] ECR I-2331, §§67-68 and §§84-86.

[60] Commission Decision, 24 March 2004, Case *COMP/C-3/37.792 Microsoft*.

customers a choice to obtain the tying product without the tied product; and (iv) the tying in question forecloses competition.[61]

The Commission found that WMP and Windows were two separate products.[62] The distinctness of products had to be assessed with a view to consumer demand, and, according to the Commission, the fact that the market provides media players separately shows that there is separate consumer demand for media players that could be distinguished from the demand for client PC operating systems. Hence, WMP and Windows were separate products. It also found that Microsoft was dominant on the market for PC operating systems.

The Commission also established that customers were not given the choice of acquiring the tying product without the tied product as Microsoft rendered the availability of Windows conditional on the customer's simultaneous acquisition of the tied product. The Commission noted that the fact that customers needed not to pay extra (WMP is distributed with Windows at no additional cost) was not a relevant consideration as the wording of Article 102(d) "does not require a reference to 'paying' when introducing the element of 'supplemental obligation.'"[63] It also noted that there is no language in Article 102 that would suggest that "in order to show coercion, customers need to be forced to use the tied product."[64]

As to the element of foreclosure, the Commission stated that tying has a harmful effect on competition.[65] It acknowledged, however, that there were circumstances

> "relating to the tying of WMP which warrant a closer examination of the effects that tying has on competition in this case. While in classical tying cases, the Commission and the Courts considered the foreclosure effect for competing vendors to be demonstrated by the bundling of a separate product with the dominant product, in the case at issue, users can and to a certain extent obtain third party media players through the Internet, sometimes for free. There are therefore good reasons *not* to assume without further analysis that tying WMP constitutes conduct which by its very nature is liable to foreclose competition."[66]

The Commission thus considered that the form-based approach applied to tying in its prior decisions had to be replaced by an effects-based approach that the Commission was beginning to promote at the time.[67] As a result, it followed a three-step analysis. First, the Commission

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[61]Id. at § 794.

[62] Id. at section 5.3.2.1.2

[63]Id. at § 831.

[64]Id. at § 832.

[65]Id. at § 835.

[66]Id. at § 841.

[67] It is worth noting that a very similar approach was taken in the other side of the Atlantic, in the *US v. Microsoft* case (346 U.S. App. D.C. 330), which analyzed the tying between Windows and Internet Explorer.Indeed, the Court of Appeals of the D.C. Circuit, decided to overturn the District Court's decision that had applied a per se rule to the
(continued…)

observed that given that Windows was present on more than 90% of all PCs, the tying of WMP with Windows ensured WMP unmatched ubiquity in the market. The Commission also rejected the view that other media player vendors could offset WMP's ubiquity through other distribution channels, such as installation agreements with OEMs, free downloading of their software from the Internet, etc.[68] The ubiquitous presence of WMP on PCs thus provided a significant "competitive advantage" to Microsoft. Second, the Commission considered that this competitive advantage would lead content providers to encode their content primarily in WMP-compatible format and application vendors to write applications primarily for WMP. The presence of strong network effects would ultimately tip the market in favour of Microsoft.[69] Finally, the Commission looked at market developments in the media player industry and identified a trend in favour of WMP.[70]As a remedy to the infringement, the Commission ordered Microsoft to offer a version of Windows for client PCs that does not include WMP.

Microsoft subsequently appealed the decision of the Commission to the GC, which delivered its judgment in September 2007.[71] In that judgment, the GC supported the position of the Commission that (i) operating systems for PCs and media players are distinct products; (ii) Microsoft is dominant on the market for operating systems; and (iii) the condition of coercion is met in that Microsoft does not give consumers the option of obtaining Windows without WMP.

However, as far as the condition of foreclosure is concerned, the GC departed from the effects-based approach followed by the Commission in its decision. That is made clear at paragraph 1058 of the judgment, which stated that the Commission's findings that the ubiquitous presence of WMP on PCs provided a significant "competitive advantage" to Microsoft

> "are in themselves sufficient to establish that the fourth constituent element of abusive bundling is present in this case. Those findings are not based on any new or speculative theory, but on the nature of the impugned conduct, on the conditions of the market and on the essential features of the relevant products. They are based on accurate, reliable and consistent evidence which Microsoft, by merely contending that it is pure conjecture, has not succeeded in showing to be incorrect."

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tying accusation, ordering the lower court to reevaluate Microsoft's conduct under the *rule of reason* (effects-based approach). Just as in the EU case, the software market was considered sufficiently complex not to allow the application of a per se rule (form-based approach). In the words of the Court of Appeals: "We remand the case for evaluation of Microsoft's tying arrangements under the rule of reason. (...)That rule more freely permits consideration of the benefits of bundling in software markets, particularly those for OSs, and a balancing of these benefits against the costs to consumers whose ability to make direct price/quality tradeoffs in the tied market may have been impaired". 346 U.S. App. D.C. 330, at 390.

[68]Id. at § 844.

[69]Id. at § 878.

[70]Id. at § 933.

[71]Case T-201/04, Microsoft v. Commission, judgment of 17 September 2007, 2007 ECR II-3601.

Hence, according to the GC, it is sufficient to show that WMP was ubiquitous on PCs to demonstrate that the tying in question creates a competitive advantage that rivals are unable to replicate. Once such a competitive advantage has been demonstrated, it is no longer necessary to show that the tying produces foreclosure effects in the market in question.

3. The modernisation of the EU law of abuse of dominance and the 2005 Discussion Paper

Roughly at the time Neelie Kroes became Competition Commissioner, it became clear that the Commission needed to move away from its form-based approach and embrace the effects-based approach it had already adopted with respect to the enforcement of Article 101. The first step in that direction came with the major policy speech given by Commissioner Kroes at the Fordham international antitrust conference in September 2005 in which she declared that she was:

> "convinced that the exercise of market power must be assessed essentially on the basis of its effects in the market, although there are exceptions such as the per se illegality of horizontal price fixing. […] Article [102] enforcement should focus on real competition problems: In other words, behaviour that has actual or likely restrictive effects on the market, which harm consumers. […] Low prices and rebates are, normally, to be welcomed as they are beneficial to consumers."[72]

Commissioner Kroes' speech was immediately followed by a Commission Discussion Paper on Article 82 EC (now 102 TFEU),[73] which promoted the very effects-based approach announced by the Commissioner. While the new economics-based principles guiding the approach proposed in the Discussion Paper were largely welcomed by commentators, the ways in which the Commission proposed to analyze certain categories of conduct were criticized as too reminiscent of the old formalistic approach.[74] This being said, the Discussion Paper largely met its objective of stimulating debate as it was subject to abundant commentary, conferences, and events.

4. The 2008 Guidance Paper

The next steps for the Commission were not clear as there was, for instance, speculation on whether the Discussion Paper would be turned into guidelines. While Commission officials were regularly recalling the Commission's intention to pursue an effects-based approach, no further move was made for almost three years before the Commission published a Guidance Paper on its

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[72]NeelieKroes, "Preliminary Thoughts on Policy Review of Article 82", Speech at the Fordham Corporate Law Institute New York, 23 September 2005, available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/537&format=HTML&aged=1&language=EN&guiLanguage=en.

[73] DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses, December 2005, available at http://ec.europa.eu/competition/antitrust/art82/discpaper2005.pdf.

[74]C. Ahlborn , V. Denicolò , D. Geradin and J. Padilla, "DG Comp Discussion Paper on Article 82: Implications of the Proposed Framework and Antitrust Rules for Dynamically Competitive Industries", available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=894466

enforcement priorities in applying Article 82 of the EC Treaty (now Article 102 TFEU) to abusive exclusionary conduct by dominant undertakings (hereafter, the "Guidance Paper").[75] This document is of a *sui generis* nature as it "sets out the enforcement priorities that will guide the Commission's action in applying Article [102] to exclusionary conduct by dominant undertakings."[76] The Commission does not therefore state or restate the way in which Article 102 should be interpreted, a task which falls within the exclusive remit of the ECJ, but explains the circumstances in which a given dominant firm's conduct is likely to be subject to enforcement action by the Commission.[77]

The Guidance Paper focuses only on exclusionary abuses leaving aside exploitative abuses and price discrimination. The Guidance Paper seeks to address the two criticisms referred to above. First, the Guidance Paper seeks to provide a definition of anticompetitive foreclosure (which is another formulation of the notion of exclusionary abuse) that carries more substance than the vague and largely unhelpful definitions referred to above. Second, the Guidance Paper signals that the Commission will pursue an effects-based approach in its enforcement of Article 102 TFEU.

The Guidance Paper defines the term "anticompetitive foreclosure" as:

> "a situation where effective access of actual or potential competitors to supplies or markets is hampered or eliminated as a result of the conduct of the dominant undertaking whereby the dominant undertaking is likely to be in a position to profitably increase prices to the detriment of consumers."[78]

This definition suggests that a two-stage test will be relied upon to assess whether a given conduct is anti-competitive. In accordance with such test the Commission should first establish the presence of foreclosure and then prove that such foreclosure will likely harm consumer welfare. The reference to consumer welfare is important as it suggests that a conduct that would merely affect the "structure of competition" by, for instance, eliminating less efficient competitors but that would have no effect on prices or on the quality of products, or innovation, and thus would not harm consumers, would not lead to enforcement action by the Commission under Article 102. It is thus the presence of (likely) consumer harm that will trigger the intervention of the Commission.

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[75] Guidance Paper, supra note 7.

[76] Id. at § 2.

[77] See Commission Decision of 13 May 2009, COMP/37-990 Intel, available at http://ec.europa.eu/competition/sectors/ict/intel.html, at § 916: "The guidance paper is not intended to constitute a statement of the law and is without prejudice to the interpretation of Article [102] by the Court of Justice or the Court of First Instance. As a document intended to set priorities for the cases that the Commission will focus upon in the future, it does not apply to proceedings that had already been initiated before it was published, such as this case."

[78] Guidance Paper, supra note 7, at § 19.

The Guidance Paper then lists a number of factors that will generally be relevant to its assessment of foreclosure, including: the position of the dominant undertaking, the conditions on the relevant market, the position of the dominant undertaking's competitors, the position of the customers or input suppliers, the extent of the allegedly abusive conduct, possible evidence of actual foreclosure, and direct evidence of any exclusionary strategy.[79]

Finally, the Guidance Paper indicates that the Commission will normally intervene under Article 102 where there is "cogent and convincing evidence" that the allegedly abusive conduct "is likely to lead to anticompetitive foreclosure."[80]It also provides that the assessment of a given conduct will "be made by comparing the actual or likely future situation in the relevant market (with the dominant undertaking's conduct in place) with an appropriate counterfactual, such as the simple absence of the conduct in question or with another realistic alternative scenario, having regard to established business practices."[81]

The Guidance Paper also contains a section dealing with price-based exclusionary conduct. It states that to prevent anti-competitive foreclosure, the Commission "will normally only intervene where the conduct concerned has already been or is capable of hampering competition from competitors which are considered to be as efficient as the dominant undertaking."[82] As the objective of competition is not to protect (less efficient) competitors, the "as efficient test" is certainly conceptually correct, although its application may at times raise significant difficulties.

The Guidance Paper states that the cost benchmarks the Commission will normally use to perform the "as efficient competitor" test are the average avoidable cost (AAC) and long-run average incremental cost (LRAIC).[83] In practice, when the price of a product is not sufficient to cover the AAC of producing the good or service in question ($P_e<AAC$),[84] this means that the dominant firm sacrifices profits in the short term and that an "as efficient competitor" will not be able to serve the targeted customers without incurring a loss.[85] Failure to cover LRAIC ($P_e<LRAIC$) indicates that the dominant firm is not recovering all the fixed costs of producing the good or service in question and that an "as efficient competitor" could be foreclosed from the market.[86]

The Guidance Paper provides that if the data clearly suggest that an as efficient competitor can compete effectively with the dominant firm's price conduct, the Commission will "in principle"

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[79]Id. at § 20.

[80] Guidance Paper, supra note 7, at § 20.

[81]Id. at § 21.

[82]Id. at § 23.

[83]Id. at § 26.

[84]P_e is the price effectively paid by the customer (for instance, the list price minus a rebate).

[85]Guidance Paper at § 26.

[86] Id.

infer that this conduct is unlikely to adversely impact effective competition, and thus consumers, and will be therefore unlikely to intervene.[87] If, by contrast, the data suggest that the price charged by the dominant firm has the potential to foreclose as efficient competitors, the Commission will integrate this into the general assessment of anticompetitive foreclosure, taking into account other relevant quantitative and/or qualitative evidence (see the foreclosure analysis discussed above).[88] This language is important as it makes clear that under the Guidance Paper the performance of a price cost test is necessary, but not sufficient to determine the presence of foreclosure. Indeed, while a price cost test may establish that by granting aggressive rebates to a given customer a dominant firm may foreclose as efficient competitors from supplying this customer, the demand of such customer may be insufficient (because it for instance only represents 5% of the overall demand) to drive as efficient competitors from the market.

The Guidance Paper indicates that the Commission intends to examine claims by a dominant firm that its conduct is objectively "justified" or that it generates "efficiencies" that are sufficient to guarantee that no net harm to consumers is likely to arise.[89] As far as efficiencies are concerned, the dominant firm that adopted the conduct leading to the foreclosure of competitors must "demonstrate, with a sufficient degree of probability, and on the basis of verifiable evidence" that the following cumulative conditions are met: (i) "the efficiencies have been, or are likely to be, realised as a result of the conduct"; (ii) "the conduct is indispensable to the realisation of these efficiencies"; (iii) "the likely efficiencies brought about by the conduct concerned outweigh any likely negative effects on competition and consumer welfare in the affected markets"; (iv) "the conduct does not eliminate effective competition, by removing all or most existing sources of actual or potential competition."[90]

The Commission will thus accept efficiency defences provided that conditions comparable to those found in Article 101(3) TFEU are met.[91] It is questionable whether many dominant firms that engage in a conduct that leads to anti-competitive foreclosure will be able to satisfy this test as the conditions are particularly stringent when placed in a dominance context. In any event, this test cannot be passed successfully by so-called "ultra-dominant" firms as the Guidance Paper provides that "exclusionary conduct which maintains, creates or strengthens a market position approaching that of a monopoly can normally not be justified on the grounds that it also creates efficiency gains."[92]

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[87]Id. at § 27.

[88] Id.

[89] Id. at §§ 27-30.

[90]Id. at § 29.

[91]Under Article 101(3), an agreement "which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not: (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;(b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question" are compatible with the TFEU.

[92]Id. at § 29.

V. Effects-based analysis with some twists: Abuse of dominance in Brazilian law

Although the first full-fledged Competition Act dates back to 1962[93], a substantial evolution of Brazilian competition law occurred more recently, following the approval of the Competition Act 8.884/94 and the implementation of market-oriented reforms during the 1990s.By that time, the modern economic theory on vertical restraints was already well established and there was a consensus that a form-based approach towards these types of conduct was not desirable.

Thus, it should not be a surprise that Brazilian Competition Law System has been very assertive in establishing an effects-based approach towards vertical restrictions. Indeed, the Brazilian Competition Act (BCA) established a system where all illegal conduct shall be evaluated according to its actual or potential effects (Article 20). Based on this provision, Brazilian Competition Law System has consistently affirmed that all vertical restraints should be evaluated in the light of a *rule of reason* (effects-based approach), according to which the negative impacts and potential efficiencies must be balanced in order to establish the net effects of the conduct under investigation. It is only when such net effects are considered negative that a vertical restraint should be deemed illegal under BCA.

However, there are some twists in the way Brazilian Competition Law System has been implementing this effects-based analysis. Despite the general approach based on the *rule of reason*, a closer look at the case law shows some inconsistency towards the actual implementation of this type of analysis. Indeed, the Brazilian Competition Law System has been applying different standards of proof to different cases, with some decisions applying such a low standard to show "potential effects" or "the anticompetitive scope of the conduct" that they come close to a form-based approach.

Against this background, this Part will be divided into three sections. Section A provides a brief introduction to Brazilian competition law, with a focus on Articles 20 and 21 of BCA, which remain substantially unchanged under the New Brazilian Competition Law (NBCA). Section B analyzes the case-law of the Brazilian Competition Law System regarding vertical restraints, which has developed an effects-based approach, establishing some criteria to evaluate this conduct. Then, Section C attempts to illustrate how the shifting standards of proof applied by Brazilian authorities generate some inconsistency and lead to some cases resembling a form-based approach.

A. Brief introduction to Brazilian competition law

As discussed above, Brazilian Competition Law developed particularly quickly following the enactment of the BCA in 1994, which established a detailed system to punish anticompetitive conduct and to control concentrations (i.e. mergers, acquisitions, joint-ventures and other

[93] The first competition act in Brazil was Law 4.137/62. However, the first rules specifically addressing competition issues were enacted even earlier, in the forties (Act 7.666/45).

transactions with an impact on market structure). Regarding anticompetitive conduct, the core of the BCA is established in articles 20 and 21. Article 20 provides that any conduct, regardless of its form, which may have the "scope" to achieve or may produce certain "actual or potential effects" (i.e. restriction of competition, illegitimate dominance of markets[94], abuse of a dominant position, or arbitrary increase in profits) shall be deemed illegal under the BCA. Article 21 provides a list of examples of conducts that may be considered illegal if it falls within the provision of Article 20. The list of potential violations covers all "traditional" anticompetitive conduct, including the vertical restraints covered in this paper (exclusive dealing, loyalty discounts, and tying), as well as some additional conduct (price discrimination, resale price maintenance, etc.).[95]

The main enforcement bodies under the BCA were the Secretariat of Economic Law (SDE) and the Administrative Council for Economic Defense (CADE).[96] While the SDE acted as the main investigative body (opening cases, conducting the discovery phase and issuing non-binding opinions), CADE acted as an Administrative Tribunal, judging the cases opened by SDE, with authority to issue infringement decisions and impose fines, which may vary from 1% to 30% of the total turnover of the undertaking in the year prior to the beginning of the investigation[97]. All decisions adopted by CADE could be challenged before federal courts. Although many conduct cases are taken to the federal courts, CADE's case law remains the main reference for the standards applied in Brazilian Competition Law.

In December 2011, the new Brazilian Competition Act (NBCA) was published and it entered into force within 180 days, on May 29th, 2012. The NBCA implemented significant institutional changes, including the merger of the SDE and CADE into a single authority, with increased powers and resources, as well as a new pre-merger review system. However, regarding the definition of anticompetitive conduct and the characterization of infringement, the NBCA keeps the system established by BCA basically intact. The new Article 36 is a combination of the old articles 20 and 21, keeping exactly the same wording for the definition of infringement based on effects of the conduct, as well as a very similar list of examples of potential anticompetitive conducts. The main change implemented by NBCA regards the range of fines: 0.1% to 20% of

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[94]Dominance acquired on the basis of efficiency is expressly considered legitimate under the BCA (Article 20, 1st paragraph) and shall not be considered an infringement in itself.

[95] Article 21 provides 24 examples of potential violations, expressly including price discrimination and tying (article 21, items XI, XII and XXXIII), as well as some general violations such as creating barriers to new competitors and blocking access of competitors to raw materials and distribution chains which clearly may include exclusive dealing (article 21, items IV and VI). Loyalty discounts are not dealt with directly, although the BCA mentions discounts to chains of distributions (article 21, IX) and refers to general foreclosure strategies.

[96]Besides, SDE and CADE, BCA also attributes authority to the Secretariat of Economic Monitoring (SEAE), which is part of Brazilian Competition Law System. SEAE has the authority to issue non-binding opinions in conduct cases opened by SDE. However, over the years, SEAE has focused its attention on merger review, establishing an informal division of labor with SDE, where the latter takes care almost exclusively of the conduct cases.

[97]BCA, article 23.

the total turnover of the undertaking in the "sector of economic activity" where the infringement took place,[98] in the year prior to the beginning of the investigation.

B. Vertical restraints as exclusionary abuses: Review of Brazilian Case-Law

The general framework for analyzing vertical restraints in Brazilian Competition Law was established in the annexes of CADE's Resolution 20, enacted in 1999.[99] Annex I of Resolution 20 establishes an effects-based approach towards vertical restraints, in line with the modern economic theory described above:

> "(…) in order to be capable of harming competition, vertical restraints usually require [the undertaking] to hold market power in the "original" market, [with the conduct] producing effects on a significant part of a "target" market. Although in theory such restraints might hinder competition [in a given market], they might also present offsetting economic efficiencies that must be balanced against potential anticompetitive effects, according to a rule of reason approach"[100]

Following this general guideline, Annex II of Resolution 20 and the Brazilian case law[101] developed a three-step approach towards vertical restraints. First, the authorities verify whether the investigated party is in a dominant position, as most vertical restraints are assessed in the context of an abuse of dominance (as in the EU). Second, it is important to show whether *market foreclosure* would be a rational strategy for the dominant firm and whether it would be likely to harm competition. Third, the authorities must balance the potential negative effects against redeeming efficiencies in order to verify the net effects of the conduct.

However, the wording of Resolution 20 is quite broad and abstract in designing such an effects-based analysis, leaving substantial room for enforcement authorities to develop more precise criteria through case law. The next few topics will address the general features of CADE's case law.

1. Exclusive Dealing

Following the general framework of Resolution 20, CADE has usually taken an approach favouring an effects-based analysis to exclusive dealing. In this approach, CADE recognizes that

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[98] NBCA, article 37. It is not clear how CADE will interpret the expression "sector of economic activity" used by the new law to calculate the fines.

[99]Published in the Official Federal Gazette in June, 28, 1999. Although part of Resolution 20 was revoked by the CADE's internal rules of procedure, its annexes with the analytic framework for anticompetitive conduct remain in force since 1999, with no amendments.

[100] Resolution 20/1999, *Annex* I, Item B.

[101] The general framework of analysis applied by Brazilian Competition Law System is described by Paulo Furquim de Azevedo. Paulo Furquim de Azevedo, "Restrições Verticais e Defesa da Concorrência: A Experiência Brasileira", (2010) Textos Para Discussão n. 264, FGV-EESP.

exclusive dealing may produce negative effects on competition, but it may also be justified in many circumstances. Indeed, in a unanimous decision issued in 2011, the Reporting Commissioner stated that:

> "As SDE correctly pointed out, exclusivity agreements, such as those under investigation, must be analyzed under the rule of reason, it being necessary to balance the agreement's potential restriction of competition against the offsetting positive impacts it may also produce."[102]

In implementing this approach, CADE usually identifies market foreclosure as the main potential negative effect of exclusive dealing, which may create difficulties for other established undertakings (preventing them from reaching suppliers upstream and/or distribution channels downstream), and may raise barriers to entry for new competitors (requiring them to enter both the downstream and upstream markets in order to become effective competitors).[103]Foreclosure concerns are usually stated by CADE very broadly and in somewhat vague terms, with a qualitative approach to the potential negative effects of exclusive dealing.

In some cases, the SDE and CADE have even attempted to calculate the level of foreclosure in order to identify the negative impact of certain conduct on competition.[104]For instance, in one of the first exclusive dealing cases investigated under the BCA, which involved Souza Cruz (the Brazilian Affiliate of British American Tobacco - BAT), the SDE calculated the "foreclosure index" for different geographic relevant markets involving the retail of cigarettes (including open spaces in different neighbourhoods, as well as airports and shopping malls, the latter pair defined as separate relevant markets).[105] In another case, involving exclusive dealing in the retail of cellular phones by a dominant telecommunications operator, ANATEL (the telecommunications

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[102] Preliminary Investigation 08700.000558/2008-75. Claimant: Rio Uerbe – Empresa Municipal de Urbanização, Defendant: Ortosíntese Indústria e Comércio Ltda., Reporting Commissioner Olavo Chinaglia, DOU: July, 15, 2011.

[103] Administrative Proceeding 08012.002841/2001-13, Claimant: Condomínio Shopping D, Defendant: Center Norte S/A – Construção, Empreendimento, Administração e Participação, Reporting Commissioner Roberto Augusto Castellanos Pfeiffer, DOU: March, 8, 2005 ("Obviously there is not a complete foreclosure in this case. However, Law 8.884/94 was created to avoid this situation. If the conduct's effects, even if only potentially or partially, foreclose a market, [such finding] is enough to prove the illegality and the offense to the economic order.").

[104] For instance, in an important precedent, Commissioner Pfeiffer proposed to determine the level of market foreclosure by measuring "the effect of the exclusivity clause in a relevant area to determine the application of the Competition Act, considering the parties' influence in the market segment, the trade volume covered by the restriction vis-à-vis the total trade volume in the respective relevant market and the effects of the practice on free competition". Administrative Proceeding 08012.009991/1998-82, Claimant: Participações Morro Vermelho Ltda., Defendant: Condomínio Shopping Center Iguatemi e Shopping Centers Reunidos do Brasil Ltda., Reporting Commissioner Roberto Augusto Castellanos Pfeiffer, DOU: April, 14, 2004. Reporting Commissioner Vote at 52.

[105] Administrative Proceeding 08012.003303/1998-25, Claimant: Philip MorisBrasil S/A, Defendant: Souza Cruz S/A, Reporting Commissioner Ricardo Villas BôasCueva, DOU: October, 7, 2005.

regulator)[106] and CADE also attempted to measure the degree of market foreclosure achieved in different municipalities.[107]

However, there is no clear guideline as to the levels of foreclosure needed for exclusive dealing to be considered anticompetitive. Indeed, in the *CRT Case,*[108] with reference to international literature and cases in the EU and the US, CADE expressly avoided defining a level of foreclosure below which exclusive dealing by a dominant firm would be safe. In this case, the Reporting Commissioner expressly rejected the argument of the parties that exclusive dealing at the retail level with market foreclosure below 40% would generally be acceptable.

CADE also expressly recognized efficiencies associated with exclusive dealing, mentioning many examples of such efficiencies in different cases:

> "According to settled scholarship and case law, exclusive dealing is only justifiable while protecting investments against undue appropriation by third parties [without proper compensation for the use] –known as the free riding effect."[109]
>
> "The arguments above indicate that clauses present in the contract executed between CVRD and Samitri, such as exclusivity [obligations], (…) are necessary for this venture as the substantial investments in specific assets made by both companies require clear rules defining risk sharing."[110]
>
> "(…) [M]aintaining an exclusivity agreement with the investigated company is justifiable considering such company's commercial strategy, the cost reductions enabled by the exclusivity, and the fact that it does not impose any risks on the good functioning of markets."[111]

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[106] Under the BCA and the General Telecommunications Act, ANATEL had authority to open antitrust cases in the telecommunications sector, sending the case for CADE's judgement (Act 9.472/97, Article 19, XIX). Under the NBCA, ANATEL will not have such authority any more.

[107] Administrative Proceeding 53500.000502/2001, Claimant: Telet S.A..Defendant: Celular CRT S.A., Reporting Commissioner Luís Fernando Rigato Vasconcellos, DOU: June, 23, 2008.

[108]*Id.* 107.

[109] Administrative Proceeding 08012.002841/2001-13, Claimant: Condomínio Shopping D, Defendant: Center Norte S/A – Construção, Empreendimento, Administração e Participação, Reporting Commissioner Roberto Augusto Castellanos Pfeiffer, DOU: March, 8, 2005, Reporting Commissioner vote at 33. Despite recognizing the potential efficiency, CADE condemned Shopping Center Norte for exclusive dealing in this case, considering a negative net effect of territorial exclusivity in the agreement between the Shopping Mall and some of its key tenants.

[110] Administrative Proceeding 08012.007285/1999-78, Claimant: SDE "ex officio", Defendant: Companhia Vale do Rio Doce – CVRD, Reporting Commissioner Thompson Almeida Andrade, DOU: May, 7, 2004, Reporting Commissioner vote at 4. CADE recognized that Samitri and CVRD had made mutual investments in specific assets related to transport of iron ore, justifying a long term relational contract with exclusivity in order to protect such investments. .

[111]Preliminary Investigation 08012.005307/2002-40, Claimant: Amadeus Global Travel Distribution S.A, Amadeus Brasil Ltda., Defendant: Sabre International Inc., Reporting Commissioner Fernando de Magalhães Furlan, DOU: (continued…)

Thus, the above discussion illustrates the general effects-based approach of CADE towards exclusive dealing, allowing for substantial debate over (i) the levels of foreclosure that should be considered harmful, according to the specific market conditions, and (ii) defences based on efficiencies associated with exclusive dealing. However, even in the most complex cases, the balancing of the negative effects against the potential benefits of exclusive dealing has been carried out on the basis of qualitative arguments, with few efforts to rely on a more detailed quantitative analysis.

A good example of this qualitative balancing between negative effects and potential benefits of exclusive dealing can be found in the *Iguatemi Cases 1*[112]and *2*[113]. Iguatemi is the best known luxury Shopping Mall in São Paulo and is considered dominant in its relevant geographic market (an area in the Southwest Region of São Paulo).The firm was investigated and condemned in two important cases, both involving exclusive dealing with its tenants: the first case examined exclusivity clauses that prohibited certain tenants from installing shops in competing Shopping Malls *(Iguatemi 1)*, while the second case examined the imposition of territorial exclusivity on certain tenants, requiring them not to install shops in a pre-determined area around Iguatemi (*Iguatemi 2*).

In both cases, CADE evaluated the negative effects of the clauses on competition and their potential benefits (e.g. alleged protection from free riding and strengthening of competition through differentiation of tenant mixes). In *Iguatemi 1,* the conclusion of this balancing exercise was that the measure in question had a net negative effect on competition, with all alleged potential benefits being refuted in light of the circumstances of the case.[114] In *Iguatemi 2*, the balancing exercise was more complex, as the imposition of territorial exclusivity could be considered reasonable to the extent that it protected *Iguatemi* from having its tenants establishing competing stores in the vicinities of its premises. However, CADE considered the territorial exclusivity overly broad, establishing an exclusive area beyond what could be considered reasonable and also covering other shopping malls in this area, with similar effects to the clause assessed in *Iguatemi 1.* In this case, the negative effects were considered to outweigh the potential benefits.[115]

December, 12, 2008, Reporting Commissioner report at 8. CADE accepted the justifications and considered the market open for other competitors, dismissing the case.

[112]Administrative Proceeding 08012.009991/1998-82, Claimant: Participações Morro Vermelho Ltda. Defendant: Condomínio Shopping Center Iguatemi and Shopping Centers Reunidos do Brasil Ltda, Reporting Commissioner:Roberto Pfeiffer, DOU: April, 14, 2004

[113]Administrative Proceeding 08012.006636/1997-43, Claimant: Associação dos Lojistas de Shopping do Estado de São Paulo and Procuradoria Geral do CADE, Defendant: Condomínio Shopping Center Iguatemi, Reporting Commissioner: Luís Fernando Rigato Vasconcellos, DOU: September, 19, 2007

[114]*Id.,* at 61-75. Note that the conclusion of the Reporting Commissioner was that in other circumstances exclusive dealing between shopping malls and tenants may be admitted, but none of these circumstances were present in the case.

[115] For a more detailed analysis of this balance see Furquim, *supra* note 101, at 25-28.

As discussed below, the general standards established by the case law and the qualitative nature of balancing the costs and benefits of the restrictions create room for inconsistencies, as CADE does not have a clear method to evaluate the net effects of particular conduct.

2. Loyalty Rebates

CADE has issued very few decisions on loyalty rebates and even those decisions usually concerned conditional discounts that were deemed equivalent to exclusive dealing or tying/bundling, raising general concerns of market foreclosure.[116]

In one precedent (*Paiva Piovesan v. Microsoft*),[117] Microsoft was accused of offering substantial volume discounts for certain distributors, thereby blocking the distribution of the financial software called Finance, which was produced by its competitor *PaivaPiovesan*. In this case, CADE found that offering discounts to a few distributors was insufficient to foreclose access to the downstream market, as the market was composed of several distributors and resellers that were still open to sell competing software.[118]

Paiva Piovesan also alleged anticompetitive effects caused by the inclusion of the software Microsoft Money "for free" together with its package of applications called Microsoft Office for Small Business (MOSB).[119] This alleged infringement was not analyzed as a discount but as a tying arrangement between the two products (Microsoft Money and Microsoft Office). As discussed below, the accusation was dismissed because there was no evidence of coercion, as customers were allowed to buy the two products separately.

The most important case concerning loyalty discounts involved Ambev (*Ambev Case*),[120] the Brazilian affiliate of ABInBev and the leading brewery in Brazil. Ambev was accused of using loyalty discounts (actually implemented in the form of a prize system composed of attractive perks) to foreclose competitors' access to bars and other retail outlets. CADE deemed the

[116]One of the first cases of loyalty discounts judged by CADE after the enactment of BCA referred to newspaper advertisements. Processo Administrativo 08000.000128/1995-98 and PA 08000.16153/1995-89 – Claimant: Empresa Folha da Manhã S/A, Defendant S.A. O Estado de São Paulo, Reporting Commissioner João Bosco Leopoldino da Fonseca, DOU: June, 19, 2000. The two largest newspapers of São Paulo (O Estado de São Paulo and Folha de São Paulo) offered substantial discounts for companies willing to concentrate all advertisements in a single vehicle. The conduct of both newspapers was deemed equivalent to an exclusive dealing arrangement and condemned by CADE. Since then, most discounts analyzed have similar features, i.e. the possibility of using discounts as means to assure exclusive dealing.

[117]Administrative Proceeding 08012.001182/1998-31, Claimant: Paiva Piovesan Engenharia & Informática Ltda., Defendant: Microsoft Informática Ltda., Reporting Commissioner: Thompson Andrade, DOU: February, 18, 2005

[118]*Id.* at 8-9

[119]*Id.* at 1

[120] Administrative Proceeding 08012.003805/2004-10, Claimant: Primo Schincariol Indústria de Cervejas e Refrigerantes S/A, Defendant: Companhia de Bebidas das Américas - Ambev, Reporting Commissioner: Fernando de Magalhães Furlan, DOU: August 5, 2009.

conduct anticompetitive, considering that the discount, together with an aggressive marketing policy, led to a de facto exclusive arrangement. In the words of the Reporting Commissioner:

> "As a relevant portion of the points of sale (POS) [surveyed] recognized, the negotiation of a *de facto* exclusivity agreement (or the simple limitation of the possibility of purchasing competitors' beers) was considered a key [informal] condition of the Conditional Rebates Program. The noncompliance with this requirement could lead to an exclusion from the Program or the non-renewal of the contract, depending on the considered period."
>
> "By combining the documents [obtained] during the inspection [made at AMBEV's headquarters], IBOPE's field research and POS's statements, the minimum standard of proof [necessary for a conviction] was reached. Due to them, it is possible to hold that the Tô Contigo Program includes, even if not in a systematic way, the requirement of exclusivity of sales [of Ambev's products] or at least some limitation on purchasing beer from third parties."

Besides the conclusion that the loyalty program led to exclusive dealing, at least with some of the retailers affected, CADE also addressed some more complex issues: (i) the discount was considered non-linear, requiring the maintenance of a certain minimum volume to obtain discounts, with the potential to gain additional rebates (in the form of larger prizes within the Program) for larger volumes; (ii) CADE and SDE tried to simulate the discounts that competitors would have to offer to match Ambev's program with lower market shares; (iii) CADE and SDE also used an independent polling institute to ascertain retailers' perceptions of the program (although the methodology of the poll was contested by the defendant) and used the poll results in the final decision to support findings beyond the formal structure of the program.

This case remains the only detailed analysis of loyalty programs in Brazil. Yet, many issues were left open: (i) there was no actual measurement of the level of foreclosure created by the loyalty program; (ii) no sophisticated test attempted to identify whether "equally efficient" competitors could replicate Ambev's program (in fact, the only test was a rudimentary attempt to estimate the level of discount necessary to match the savings achieved by Ambev's program, with no actual evaluation of the contestable portion of the market or the costs incurred by the defendant in the relevant intervals of output) and (iii) no detailed discussion of justifications and efficiencies, which were simply rejected without further analysis.

The main problem in this case was thus that CADE did not perform a thorough analysis of market foreclosure before considering the practice anticompetitive. In fact, according to SDE's report, Ambev argued that the loyalty program reached 10%-12% of points of sale and around 10% of the volume of sales[121], a small portion of the market under any standard. With a small portion of the market affected by the conduct, competitors would still have access to the vast majority of the points of sale. Thus, even if CADE were correct, and the program actually led to

[121] *Id.* SDE Report, *at* 5, 9 and 11.

exclusivity at the points of sale covered by loyalty contracts, the level of foreclosure would be low and, therefore, the conduct would be unlikely to generate anticompetitive effects. In this context, it might even have been unnecessary to go deeply into "equally efficient" tests or into a balancing exercise of efficiencies.

Yet, CADE considered the overall aggressive marketing policy sufficient to prove the anticompetitive effects of the program. Indeed, the analysis turned more on the alleged objective of the conduct and the *potential* effects of the program in order to reach a conviction, rather than on the actual effects of the conduct. By doing so, the outcome came closer to a form-based analysis, even though CADE claimed that the analysis was effects-based.

In this respect, it is also interesting, although unsurprising, to note that CADE's final decision was influenced by EU competition law, with explicit references to the EU's case law and methods of analysis in order to support the conclusion that loyalty discounts of the type implemented by Ambev had exclusionary effects. As CADE's final decision was issued in 2009, it also made express references to the EU Guidance Paper published at the end of 2008. Thus, CADE argued it was applying the "state of the art" of the European discussion.

However, as described above, the decision clearly fell short of the standards proposed by the European Commission. Indeed, applying the proposed standards would have required a more rigorous analysis, with deeper understanding of the conduct's ability to affect "equally efficient" competitors, the level of foreclosure it created, and whether it was compensated by the potential efficiencies it created with respect to Ambev's overall distribution system.

3. Tying

Over the past 10 years, CADE has dealt with around 30 cases involving tying, with no full-fledge condemnation of this type of conduct. Most of these cases were relatively simple and did not establish any clear test or guidance for future cases. Yet, a few of the cases do contain a more refined discussion of the standards for assessing tying.

The general framework of analysis does not differ substantially from other vertical restraints. CADE maintains an effects-based approach, balancing negative effects against potential efficiencies. In the case of tying, CADE incorporates a four-prong test inspired by the international literature and case law, stating that:

> "(...) the finding of an illegal tying conduct demands the analysis of some requirements, such as the: a) existence of two separate products and/or services; b) existence of some element of coercion; c) existence of dominant position in the tying market; d) characterization of anticompetitive effects, either on the tying market or the tied market."[122]

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[122] Preliminary Investigation 08700.005025/2007-07, Claimant: Tribunal de Contas da União - TCU, Defendant: Aceco TI Ltda. (Aceco Produtos para Escritório e Informática Ltda.), Reporting Commissioner: Ricardo Machado Ruiz, DOU: June 30, 2010.

Most cases do not reach the stage of analysis where the negative effects of the tying conduct are balanced against the pro-competitive effects (balancing test); the tying claims are typically dismissed either because there is only one product,[123] there is no proof of coercion,[124]or because the party engaging in tying does not have market power in the tying product market.[125] For this reason, it is very difficult to extract clear bright line rules as to how CADE balances the negative effects of the conduct against its potential efficiencies.

However, in at least one precedent, the *Matec Case*[126], CADE developed a more detailed analysis. Matec, a supplier of large telephone switchboards, was accused of refusing to supply spare parts to independent companies that were interested in providing maintenance services. Despite being characterized mainly as a refusal to deal case, it could also be depicted as a tying case, where Matec was tying the sale of maintenance services to the sale of spare parts for its switchboards, thereby limiting the ability of independent companies to provide maintenance services. The analysis in this case closely mirrored the famous and controversial *Kodak* judgment adopted by the US Supreme Court in 1992,[127] where Kodak was condemned for illegally tying the provision of maintenance services and the sale of spare parts.

Just as in the *Kodak Case*, Matec argued that it had several efficiency justifications for such conduct[128]: (i) the foremarket and aftermarket actually composed a single system, competing with other suppliers of switchboards, and, as such, CADE should focus on inter-brand competition in the foremarket (i.e. switchboards) and not on intra-brand competition in the aftermarket (i.e. Matec machine's related services); (ii) the vertical integration of maintenance

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[123] Preliminary Investigation 08012.004118/2002-50, Claimant: Procuradoria da República/Bauru/SP, Defendant: Unimed Bauru – Cooperativa de Trabalho Médico, Reporting Commissioner: Olavo Zago Chinaglia, DOU: May, 28, 2005. ("*In order to analyze the present case, SDE's report was based in Hovemkamp's (1999) proposed standard. The first step of the analysis requires the presence of two different products, that would be subject to the analysis, considering that one of them should be the tying product or service and the other the tied product or service*.").

[124] Administrative Proceeding 08012.001182/1998-31, Claimant: Paiva Piovesan Engenharia & Informática Ltda., Defendant: Microsoft Informática Ltda., Reporting Commissioner: Thompson Andrade, DOU: February, 18, 2005. (*"in the present case, there was no coercion to buy two packages* [of software]. (…) *Therefore, as emphacized by SEAE and SDE, one cannot verify in the present case, the necessary conditions for the characterization of tying*")

[125] Administrative Proceeding 08012.009373/1998-23, Claimant: Conservel – Conservadores de Elevadores Ltda., Defendant: Elevadores Otis Ltda Schindler Elevadores do Brasil S.A., Indústria Villares S.A., Elevadores Sür S.A., Elevadores Atlas S/A, Elevadores Kone S.A., Reporting Commissioner: Abraham Benzaquen Sicsú, DOU: August 1, 2006 (*"therefore, one can see clearly the inexistence of market power in that particular geographic market and the impossibility to characterize tying*").

[126] Administrative Proceeding 08012.000172/1998-42, Claimant: Power-Tech Teleinformática Ltda, Defendant: MatelTecnologia de Informática S/A - MATEC, Reporting Commissioner: Celso Fernandes Campilongo, DOU: May, 13, 2003

[127] Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451 (1992).

[128] See supra note 127. for a summary of Matec's arguments and CADE's rebuttals, see Commissioners Roberto Castellanos Pfiffer and Ronaldo Porto Macedo Junior concurring opinions.

services was actually a way to prevent free riding from the independent service providers; and (iii) vertical integration also prevented potential damages to the brand, by assuring the quality of the maintenance services.

CADE rejected all these justifications. The Commissioners defined the existence of two separate markets for spare parts and for maintenance services, where Matec held a monopoly on the prior market and incentives to exclude on the latter market. As to the free riding argument, Commissioner Pfeiffer expressly recognized the risk of "opportunism" from independent companies. However, he also argued that, the characteristics of the market (innovation pushed all service providers to be highly specialized and to update their services) could reduce the risk of opportunism or at least reduce its "intensity". Finally, regarding the reputation of the brand, there was no evidence of actual damage, and actually there were reasons to believe that customers could assess the product and the services separately, also considering the accreditation mechanisms used by Matec to identify "good service providers".

Thus, despite not being fully depicted and treated as a tying precedent, the *Matec Case* shows an attempt to balance potential negative effects and efficiency justifications, where CADE found net negative impacts on competition and thereby condemned Matec. Nevertheless, CADE's analysis of the net effects of the conduct in this case is essentially qualitative and somewhat superficial.

C. An effects-based approach with some twists: the impact of vague terms in shifting standards of proof

As illustrated above, Brazilian Competition Law System's position is generally in line with modern economic theory, officially adopting an effects-based perspective towards vertical restraints. In this sense, the Brazilian experience has been praised for avoiding some of the problems faced by the rigid form-based approaches that prevailed for a long time in mature jurisdictions,[129] including the EU and the US. However, the casuistic approach adopted by the Brazilian Competition Law System, with an open ended balance between negative effects and efficiency justifications, has also generated some inconsistencies.

A close look at the case law shows substantial variance in the qualitative analysis implemented by the Brazilian authorities. This variation generates inconsistency, especially when it comes to a definition of standards of proof in the context of the *rule of reason* analysis. Indeed, the relatively clear general framework for the effects-based analysis has not been capable of developing more detailed tests and standards to define when the net effects of a particular vertical restraint would be deemed negative to characterize conduct as illegal under the BCA.

In particular, Brazilian Competition Law System's initial analysis of effects has been relatively weak as it has not focused on demonstrating actual foreclosure effects nor on developing a rigorous analysis of potential effects. Such assessments require a detailed, fact-based, analysis

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[129]Azevedo, id, at 11: "*As already mentioned, the decisions' basis show a surprising consistency in the procedures of analysis [of vertical restraints], especially if considered the significant controversy existent on the subject.*"

relying on objective economic criteria, such as, for instance, the "equally efficient" competitor test in the case of rebates. However, the approach used by Brazilian authorities has not gone that far, sometimes limiting itself to observing hypothetical foreclosure to declare certain conduct anticompetitive.

As for the balancing of the pro-competitive and anti-competitive effects, this step in the analysis should only take place once foreclosure effects have been thoroughly demonstrated. In the absence of clear foreclosure effects, there is no need to develop a balancing test. On the other hand, in cases where foreclosure effects are demonstrated, an objective balancing test should then be required. Brazilian Competition Law System has, however, applied a balancing analysis based almost exclusively on qualitative considerations and intuitive reasoning, lacking a more rigorous and structured assessment. As a result, some of its decisions have been inconsistent as they were based on the subjective views of CADE's commissioners.

In fact, the original root of this problem can be found in the vague terms of the BCA itself, as Article 20 characterizes as illegal any conduct that may produce certain effects "*even if they are not achieved*" (*potential effects*) or any act "*with the scope*" to produce certain negative effects on competition (*scope of the act*). In practice, these vague terms result in some cases being dismissed with the application of strict standards of proof that require hard evidence of negative effects and other cases being condemned based on relatively relaxed standards of *potential effects* and *scope of the act*.

For instance, in one precedent addressing exclusive dealing (*Itambé Case*),[130] CADE recognized that a case could not be dismissed based on the lack of evidence of actual effects on competition, stating that:

> "(...) the absence of factual evidence proving the occurrence of anticompetitive effects is insufficient for the dismissal of a case. (...) For any given conviction, initially it is necessary that the authority proves the existence of a given conduct. Afterwards, it must be assessed whether the conduct objectively aimed to produce or had a high probability of producing anticompetitive effects. As explicitly stated in the last part of article 20 [of the BCL], finding that the conduct actually yielded anticompetitive effects is irrelevant for Brazilian Law.
>
> Therefore, even though after 4 years [of the occurrence of the conduct] no damage to the market can be observed, it cannot be stated that the practice did not have potential to produce such [anticompetitive] effects."[131]

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[130] Administrative Proceeding n. 08012.009312/1998-39. Defendant: CCPR – Cooperativa Central dos Produtores Rurais de Minas Gerais Ltda. ("Itambé"), Reporting Commissioner Abraham Benzaquen Sicsú, DOU May 18, 2007 (the case addressed, among other issues, an exclusive agreement for the sale of a particular brand of milk, and it ended up being dismissed on procedural grounds, although SDE decided to open a new case to deal with the alleged infringements).

[131] *Id.* at Reporting Commissioner vote, page 4.

If the lack of effects after four years is not sufficient to dismiss a case, which might still be pursued on grounds of *potential effects* or the *scope of the act,* then the standard of proof to characterize an infringement is in fact extremely low. To characterize the conduct as infringement, it would be sufficient to show a purely theoretical harm to competition or a simple statement of the defendant showing an objective to dominate a market. Such a low standard of proof to refuse the dismissal of a case comes very close to a form-based analysis, where a given course of conduct is presumed to have a negative effect. Even though this was not a final decision, which would have probably led to a more detailed analysis by CADE, the reporting commissioner was very clear in emphasizing that "potential effects" could be the sole ground for a conviction even in a context of no actual anticompetitive effects could be observed after four years.

A similar low standard of proof of actual negative effects seems to have been applied in the *Ambev Case,* where an allegedly low level of foreclosure (*i.e.*10%-12% of the points of sale served by Ambev) was insufficient to deem the conduct lawful and dismiss the case. Indeed, the perceived potential effects of the conduct in the context of Ambev holding a clear dominant position combined with evidence of an aggressive marking strategy was considered sufficient to declare the conduct anticompetitive. As for the balancing of the conduct's alleged anticompetitive effects with its potential efficiencies, this exercise was superficial and relied on qualitative elements.[132] Here again, CADE's analysis came close to a form-based analysis, as it did not require a clear demonstration of foreclosure or any actual balancing of potential efficiencies.

However, this is not always the case. For instance, in the *CRT Case* referred to above, another precedent on exclusive dealing, the issue about the standard of proof was put very candidly and led to a split vote of CADE's Commissioners.

In this case, ANATEL, the regulatory agency in the telecommunications sector, had gathered evidence that exclusive agreements of the dominant telecommunications operator with retailers reached high levels of foreclosure (up to 90% in some municipalities). Nevertheless, the defendants alleged that, despite the vertical restraint in question, competition was healthy and new entrants gained substantial market share during the investigated period. Invoking the wording of the BCA, and the available evidence, the Reporting Commissioner suggested the conviction of the defendant:

> "On the other hand, it is important to clarify that, according to the wording of article 20 of Law 8.884/94, a competition infringement may take place if [the conduct] has the scope to or may produce the effects mentioned in items I through IV of article 20, even if these effects are not achieved."

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[132] The analysis of efficiencies and the balancing test takes up only one page in the reporting commissioner's vote, concluding that the efficiencies are insufficient to justify the loyalty program. Administrative Proceeding 08012.003805/2004-10, Reporting Commissioner's vote, at 78-79.

> Thus, whether the conduct actually produced [anticompetitive] effects is irrelevant for the characterization of an infringement, as the simple possibility that such effects might occur is considered to be sufficient [for a conviction]. (…) Following such approach, the question being debated here is not whether the investigated conduct actually harmed competition, but rather if such conduct had a high probability of limiting competition or enabling the abuse of a dominant position (and if such risks were known by the economic agent).
>
> Due to the abovementioned reasons, I consider the defendant in breach of articles 21, V, VI and X c/c article 20, I, II and IV of Law 8.884/94"[133]

Taking an opposing view and applying a much stricter standard of proof, a Dissenting Commissioner argued for the dismissal of the case based on the lack of evidence, in the following terms:

> "The evidence contained in the records is not sufficient to indicate that the defendant has the possibility to (a) foreclose the market by requiring retailers loyalty (b) obtain monopoly profits with such strategy, preventing consumers from having access to competitors' products; (c) increase its rival's costs in a way that would be, even potentially, a strong restriction to its rivals [performance] (...) Due to the above mentioned reasons, I vote for the dismissal of this complaint, as the evidence presented is insufficient to characterize a breach of Brazilian Antitrust Law."[134]

The final decision to dismiss the case because of the lack of evidence was taken in a split vote of three to three Commissioners, with the President untying the vote.

It is very difficult to reconcile the cases discussed above. Indeed, in the *Itambé* case, the unanimous decision was that the case should not be dismissed despite the lack of evidence of actual negative effects four years after a certain course of conduct was adopted. In the *Ambev* case, allegedly low levels of foreclosure were also considered insufficient for dismissing the case. On the other hand, in the *CRT* case, despite apparent substantial evidence showing high levels of foreclosure in some municipalities, the majority vote required more evidence of actual negative effects to reach a conviction. Thus, while in the first two cases the standard of proof was set very low, focusing on the "*potential effects*" of the conduct, in the last case the standard was set quite high requiring substantial evidence of the presence of "*actual effects*".

These cases illustrate the inconsistencies generated by shifting standards of proof based on the vague terms of the BCA. Depending on the particular case, and whether CADE puts heavy weight on the language of "*potential effects*" and the "*scope of the act*", the evidence (or the lack

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[133]Administrative Proceeding 53500.000502/2001, Claimant: Telet S.A.. Defendant: Celular CRT S.A., Reporting Commissioner Luís Fernando Rigato Vasconcellos, DOU: June, 23, 2008, Reporting Comissioner vote at 25 – 26.

[134]*Id.,* Dissenting Opinion of Commissioner Luis Carlos Delorme Prado, at 3.

of evidence) considered sufficient to dismiss or convict a case may change dramatically. Some convictions based on lower standards of proof come close to a form-based approach, as they may simply ignore actual effects or any rigorous analysis of potential effects and impose a fine based exclusively on the scope of the conduct or its abstract potential effects.

In conclusion, even though Brazilian Competition Law System's general approach towards vertical restraints seems in line with modern economic theory, it is necessary to develop clearer tests to evaluate actual effects and more consistent standards of proof. In this sense, for different reasons, both the EU and Brazil seem to have a similar challenge ahead: developing an analytical framework capable of translating the modern economic theory into a consistent approach towards concrete cases. This is the subject of the next Section.

VI. Analytical framework for the application of competition rules to vertical restraints

In light of the current need for a more detailed analytical framework in the field of vertical restraints, both in the EU and in Brazil, this Part seeks to provide some bright lines for the enforcement of competition rules in this field, taking the Guidance Paper produced by the EU Commission as a starting point.

It is divided in two sections. Section A provides a set of sound legal and economic principles that should be used to analyse vertical restraints adopted by dominant firms. Section B applies these principles to the assessment of the various categories of vertical restraints analysed in this paper (exclusive dealing, rebates and tying) with specific references to the EU and Brazil.

A. Principles governing the assessment of vertical restraints

This section seeks to offer a clear conceptual path to competition authorities and courts called to assess the legality of vertical restraints adopted by dominant firms. The principles listed below are based on objective economic criteria,[135] moving away from the formalistic approach to the assessment of vertical restraints which has plagued several jurisdictions, such as the European Union and the US. The guidelines proposed here should also help countries that have already moved to an effects based analysis, but still need to do develop a more robust and consistent method of analysis, like Brazil. Key to the assessment of such restraints is to focus on the relevant issues – central to which is the presence of foreclosure – and in so doing to rely on proper economic tools.

1. Vertical restraints should not be assessed under *per se* rules

There is wide agreement among lawyers and economists that a *per se* rule of illegality against vertical restraints is not warranted. While a *per se* rule may be justified with respect to certain practices, such as, for instance, cartels, which by essence aim at suppressing the competitive process so as to charge customers supra-competitive prices, such a clear cut anti-competitive

[135] And should be implemented on the basis of relevant data.

story is not present in the case of vertical restraints. As pointed out by Herbert Hovenkamp in the context of rebates:

> "no discounting practice should ever be unlawful per se. Discounting is a vertical practice that is presumptively pro-competitive. It should be condemned only in the presence of significant market power and proven anticompetitive effects."[136]

The same remark is certainly valid for both exclusive dealing and tying, which as in the case of rebates are generally pro-competitive.

2. The form and nature of a practice are not relevant to their assessment under competition rules: Only foreclosure effects matter

For a long time, competition authorities and courts in mature jurisdictions tended to give more importance to the form or nature of vertical restraints than to their effects on competition. For instance, the treatment of rebates by the European Commission and the EU courts was essentially governed by the determination of whether the rebates were *fidelity* rebates (which were deemed per se illegal) or *volume* rebates (which could be justified in certain circumstances). While such distinctions have the merit of making things simple, they are not justified from an economic standpoint as the form and nature of a given conduct are not necessarily related to its effects.

Modern economic thinking teaches that competition authorities and courts should focus on the *effects* of vertical restraints on competition in the market. As will be seen below, whether vertical restraints create foreclosure effects may require complex analysis. Yet, failure to engage in such analysis will lead to so-called Type 1 or Type 2 errors.[137]Type 1 errors (also known as "false positives"), whereby competition authorities or courts mistakenly declare a conduct anti-competitive, leads to over-enforcement. By contrast, Type 2 errors (also known as "false negatives"), whereby competition authorities or courts mistakenly fail to identify an anti-competitive conduct, leads to under-enforcement. There is debate in the literature as to whether Type 1 errors are more frequent, than Type 2 errors, and vice-versa. As both forms of errors are damaging, it is important for competition authorities and courts to minimize them through proper analysis.

The emphasis on effects rather than form or nature raises some important questions. A first question is whether it is sufficient for a finding of infringement that the conduct in question is "liable to" or "capable of" producing anti-competitive effects or whether the "actual" presence of such effects must be demonstrated. A related question is whether competition and courts should be entitled to intervene before or only after effects have materialized. These are difficult questions as while the analysis should focus on the effects, competition authorities and courts

[136] See *OFT Report*, "Selective Price Cuts and Fidelity Rebates", Economic Discussion Paper, July 2005, OFT804, § 1.7, at 2.9 et seq.

[137] Frank Easterbrook, "The Limits of Antitrust", (1984) 63 Texas Law Review 1.

should not be bound to wait for rivals to have been entirely driven from the market by the dominant firm's anti-competitive behaviour before intervening. On the other hand, an intervention based solely on the hypothetical possibility of the materialization of effects leads to an analysis that may come very close to the deficient form-based approach, as the Brazilian experience has illustrated in some cases.

As to the first issue, it should never be sufficient for a competition authority or a court to condemn a vertical restraint on the sole ground that it is theoretically "liable to" or "capable of" of producing anti-competitive effects. Indeed, while every vertical restraint is theoretically able to generate anti-competitive effects, whether this theoretical possibility materializes depends on the facts of each case. For instance, whether conditional rebates (taking the form of fidelity rebates or volume rebates) create foreclosure effects can only be determined through a proper analysis pursuant to the methodology discussed at VI.B.2below. Absent such an analysis, determining that a conditional rebate is anti-competitive amounts to guess work. Reliance on proper foreclosure analysis also helps to address the second issue as it allows identifying a rebate as anti-competitive before rivals have suffered any material effect or at least before they have been sufficiently harmed to be driven from the market. As will be seen below, proper price cost analysis allows a competition authority or a court to determine whether a rebate granted by a dominant firm is exclusionary in that it cannot be matched profitably by smaller rivals.

In addition, it is important to note that for a vertical restraint adopted by a dominant firm to produce exclusionary effects, this restraint must foreclose a substantial share of the market. This can be made clear by the following example. Assume for instance that Firm A is dominant on the market for cement in a given country. There are ten buyers of cement each buying 10% of the quantities of cement available on the market. Firm A concludes an exclusive purchasing obligation with two of these ten buyers. While Firm A's rivals will be foreclosed from supplying cement to these two buyers, 80% of the market (i.e., the eight other buyers) remains contestable. The situation would of course be entirely different if the exclusive purchasing obligation applied to 80% of the market as this would be unlikely to leave a sufficiently large contestable share for rivals to be able to trade profitably.

3. <u>The "equally efficient" standard is the right standard of review</u>

An important question when one deals with price-related vertical restraints, such as rebates, relates to the standard of review which should be used by competition authorities and courts to assess the legality of the conduct.

In its Guidance Paper, the European Commission states that to prevent anti-competitive foreclosure, the Commission "will normally only intervene where the conduct concerned has already been or is capable of hampering competition from competitors which are considered to be as efficient as the dominant undertaking."[138] As the objective of competition is not to protect (less efficient) competitors, the "as efficient test" is certainly conceptually correct. This means

[138] Guidance Paper, supra note 7, at § 23.

that as long as a dominant firm sells its products at an effective price (standard price minus the rebate it grants to its customers) that is above a certain measure of its costs, the rebate in question should be legal even if it has the effect of eliminating weaker competitors. Tests which would rely on competitors' costs or any other benchmark exceeding the dominant firm's own costs would protect less efficient competitors and ultimately deprive consumers of the beneficial effects of price competition.[139]

It is sometimes argued that in industries characterized by economies of scale competition authorities and courts should offer protection to less efficient entrants (by preventing firms from adopting rebates that they cannot match) so as to give them the opportunity to gain market share and, thus, the scale they need to become more efficient. Such views, however, fail to convince for the following reason: *either* the less efficient entrant has a good product and a credible business plan in which case it should find sufficient capital to fund an initially loss-making entry *or* the less efficient entrant does not have a good product and credible business plan in which case there is no reason why consumers should be effectively asked to subsidize its entry by paying higher prices that they would normally pay absent competition law intervention. As pointed out by the then judge (now Justice) Breyer in *Barry Wright*:

> "a price cut that ends up with a price exceeding total cost-in all likelihood a cut made by a firm with market power-is almost certainly moving price in the 'right' direction (towards the level that would be set in a competitive marketplace). The antitrust laws very rarely reject such beneficial "birds in hand" for the sake of more speculative (future low-price) 'birds in the bush.'"[140]

4. <u>Consumer harm should be shown in that the anti-competitive effects of the restraints in question are not objectively justified or compensated by efficiencies</u>

The central purpose of competition law is to protect consumer welfare. Consumers should be protected from anti-competitive conduct as such conduct will generally translate into higher prices, reduced choice, and lower innovation. This raises the question whether one can infer from the fact that a given conduct is likely to create anti-competitive effects that consumer welfare will necessarily be harmed. To answer this question, one should determine whether the conduct in question can be justified by an objective reason or the presence of redeeming efficiencies.

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[139] Such tests would also generate a significant degree of uncertainty as it would be impossible for a dominant firm to know in advance whether its rebates would be illegal. While dominant firms obviously know their cost structure, they are in no position to know the costs of their competitors and thus could not self-assess their pricing practices. This aspect was recently emphasised by the Court of First Instance in *Deutsche Telecom* in which the Commission had applied the "as efficient competitor" test. The Court condoned this test, holding that any other approach would be contrary to the general principle of legal certainty. See judgment of the Court of First Instance, 10 June 2008, Case T-271/03 *Deutsche Telecom* (not yet published) at § 192.

[140] See Barry Wright Corp. V. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983), at 234. See also Einer Elhauge, "Why Above-Cost Price Cuts To Drive Out Entrants Are Not Predatory--and the Implications for Defining Costs and Market Power" (2003) 112 *Yale Law Journal*, 681; Aaron S. Edlin, "Stopping Above-Cost Predatory Pricing" (2002) 111 *Yale Law Journal*, 941.

Let us, for instance, assume that a dominant manufacturer of disposable razors decides to tie blades to its razors. Clearly, this may have exclusionary effects on rival producers of blades, but it does not necessarily mean that it harms consumer welfare. The dominant firm may, for instance, be able to show that there is a real danger that users of its razors may be hurt if they use lower quality blades and that the only practical manner to avoid such incidents is to tie blades to its razors. The dominant firm will, however, have to show that there is no less restrictive alternative to protect consumers, such as for instance through proper labelling or by asking health authorities to prohibit the sale of low quality blades.

Similarly, while tying may have exclusionary effects, they are also often the source of considerable efficiencies. For instance, when mobile phones manufacturers started adding a camera to their phone, this may have harmed camera producers. Yet, on the other hand, the adding of new functionalities to mobile phones has increased the value of such phones for users. Today, smart phones not only contain a phone and a camera, but also a range of functionalities that were initially found on computers, such as the ability to send emails, download online content, play games, review documents, etc. Again, this has created challenges for PC and laptop makers, but has brought considerable value to users.

B. Application of the principles to vertical restraints

In this section, we apply the law and economics principles discussed above to the analysis of vertical restraints. As will be seen, while the test or standards applying to exclusive dealing, rebates, and tying are distinct (as their effects on competition vary), they should be based on the same set of principles.

Before turning to the application of these principles to vertical restraints, it is important to recall that the first step in the analysis is to establish whether the firm adopting the vertical restraints in question is dominant in one or several relevant markets. While discussing the intricacies of market definition goes beyond the scope of this paper,[141] a few important comments need to be made with respect to the assessment of dominance. First, the assessment of dominance has no other purpose than determining whether the firm that is subject to investigation / litigation holds substantial market power, which translates into the ability to charge supra-competitive prices.[142] Key to this determination is whether the investigated firm is subject to constraints preventing it from charging supra-competitive prices. Secondly, while market share is often used as a first screen to determine the presence of a dominant firm in the relevant market, market share alone is a blunt surrogate for establishing dominance.[143]A high market share may reflect nothing more

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[141] On market definition, see Elhauge and Geradin, supra note 3, at 276 et seq.

[142] See *Guidance Paper*, supra note 7, at § 10. Damien Geradin et al., "The Concept of Dominance in EC Competition Law", *Research Paper on the Modernization of Article 82 EC*, Global Competition Law Center, 2005, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=770144

[143] See Simon Bishop, "Delivering Benefits to Consumers or Per Se Illegal? Assessing the Competitive Effects of Conditional Rebates" in *The Pros and Cons of Price Discrimination*, Swedish Competition Authority, 2005 (continued…)

than that the enterprise is responsive to customer demand, i.e., it offers high quality products at competitive prices.[144] In addition, the focus on market share is static in nature and renders no account of market dynamics.[145] For instance, a firm that enjoys a high market share may have been persistently losing customers to competitive rivals in the recent past. Overall, market share is thus not a proxy for market power, and on its own cannot justify a finding of dominance. Additional factors need to be taken into account regardless of whether market shares are very high or not.[146] Such factors, for instance, include the absence of barriers to entry or expansion, the presence of countervailing buyer power, etc.

1. <u>Exclusive dealing</u>

An exclusive purchasing obligation is an agreement to sell a product on the condition that the buyer purchases exclusively or to a large extent only from the (dominant) supplier. As we have seen in Part II, the major anticompetitive concern that may be raised by exclusive agreements is that such agreements might foreclose enough of the market to harm competition and consumer welfare. On the other hand, exclusive dealing may be a source of efficiencies. The relevant questions for a competition authority or a court are thus to determine whether the exclusive dealing obligation in question is likely to produce foreclosure effects and, if so, whether such effects are outweighed by efficiencies. The final goal of this balance is to establish whether the practice produces (or is likely to produce) a net negative effect on consumer welfare and, therefore, characterizes an infringement.

As a starting point, it is important to observe that there is no mathematical formula that allows to determine whether in a given context exclusive dealing obligations should be considered as pro- or anti-competitive. A number of factors can, however, be taken into account in the assessment of such obligations.

The first, and perhaps most important, factor relates to the size of the market share that is tied to the exclusive dealing obligation, i.e. the part of the market covered by such an obligation. As noted above, while a tied market share of 20% is generally unlikely to create foreclosure effects, the opposite can be said of an 80% tied market share. The difficulty is of course when the tied

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(“[M]arket share provides only one indicator of a firm’s market power and therefore only provides a poor proxy. Indeed, in many markets … even firms with high market shares can be subject to effective competition even from firms with very low market shares. Other factors that need to be taken into account alongside the mere calculation of market shares are the ease with which firms can expand their sales, the ease with which new firms can enter the market.”)

[144] Or, for instance, that the firm under investigation enjoys a “first mover advantage” because it was the first entrant on a new market.

[145] See *Guidance Paper*, at § 13.

[146] See, e.g., Simon Bishop, supra note 35 (“[M]arket share provides only one indicator of a firm’s market power and therefore only provides a poor proxy. Indeed, in many markets … even firms with high market shares can be subject to effective competition even from firms with very low market shares. Other factors that need to be taken into account alongside the mere calculation of market shares are the ease with which firms can expand their sales, the ease with which new firms can enter the market.”)

share is between these two extremes. In fact, there is no standard answer to the question of the amount of tied share that is likely to create foreclosure effects as this may depend on the share of the market an equally efficient supplier needs to capture to trade profitably, a question that is particularly important in markets characterized by economies of scale and scope. For instance, in a market where the minimum efficient scale (the "MES") is at 50% of the market (i.e., a duopoly), a market coverage of 60% is exclusionary, whereas in a market where the MES is at 20%, a 50% market coverage may be insufficient to foreclose the market.[147] Determining market foreclosure thus requires a case-by-case analysis.

When the dominant firm does not tie an important part of its customers to an exclusive purchasing obligation but applies it selectively to some of them, one has to investigate whether the tied customers are those that are likely to be the most responsive to offers from rivals to the dominant firm, for instance due to the characteristics of their products (which may be particularly well suited to a subset of customers) or their geographic proximity to some customers. As in the case of selective price cuts, such issues must be looked at with care as determining whether a customer is "particularly responsive" to an alternative supplier is to some extent a subjective question.

A second important criterion relates to the duration of the exclusive dealing obligation. Short obligations are generally less likely to produce foreclosure effects as they allow alternative suppliers to bid for the contracts on a regular basis. The same can be said of exclusive dealing contracts containing a provision allowing customers to terminate the exclusive dealing obligation at short notice and without penalty. Such a provision allows customers to receive offers from existing rivals or new entrants assuming of course they are not capacity constrained.

It is important to note that dominant firms may engage in practices that although falling short of outright exclusivity can have foreclosure effects, such as, for instance, fidelity / market share rebates (see next section), slotting allowances, and category management.[148] The assessment of such practices should follow the same principles as those applied to exclusive dealing obligations. Competition authorities and courts have also looked at so-called "English clauses" whereby the buyer is required to report to the dominant supplier any better offer and only allowed to accept such an offer when the dominant supplier does not match it.[149] While such clauses may be advantageous for buyers (as they create price competition among suppliers), they

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[147] Following this line of reasoning, one scholar suggests the following safe harbor: "per se legality for arrangements less than one year in duration or arrangements that foreclose less than 40% of total distribution would improve consumer welfare without significant risk of anticompetitive harm." See Joshua D. Wright, "Antitrust Law and Competition for Distribution", (2006) 23 *Yale Journal on Regulation* at 169-208.

[148] On these practices, see O'Donoghue and Padilla, supra note 35.

[149] Id. In Brazil, "English Clauses" have been discussed in at least two important cases, both of them settled with CADE: Administrative Proceeding 08012.003303/1998-25, Claimant: Philip Morris Brasil S/A, Defendant: Souza Cruz S/A, Reporting Commissioner Mercio Felski, Judged in September 13, 2000.and Administrative Proceeding 08012.006504/1997-11, Claimant: Chandre de Araújo Costa and others, Defendant: TV Globo Ltda. União Brasileira dos Grandes Clubes de Futebol (Clube dos Treze) and others. Reporting Commissioner: César Costa AlvesMattos, DOU: October 22, 2010.

may nevertheless produce foreclosure effects especially when the buyer has to reveal the identity of the rival making the better offer, as this may discourage competitors from making competing offers.[150]

If the above analysis reveals that the exclusive dealing obligation in question creates foreclosure effects, such effects must be balanced with the efficiencies that may be generated by the obligation. As seen in Part II above, exclusive dealing obligations reduce uncertainty about whether future sales, which is particularly critical when suppliers need external financing to expand or when they need to make a client-specific investment. Exclusive dealing may also be more acceptable to buyers than requirements to purchase a certain quantity of products from the dominant firm, particularly in industries where demand may fluctuate over the years. The task of competition authorities and courts is thus to balance the pro- and anti-competitive effects of exclusive dealing obligations. Such balancing is not necessarily an "all or nothing" process where exclusive dealing obligations are either entirely accepted or entirely rejected. In some circumstances, competition authorities may ask the dominant firm to allow its buyers to purchase some of their needs from rivals (turning an exclusive dealing obligation into an obligation to buy, for instance, at least 75% of the buyers' need from the dominant firm, hence leaving 25% to rivals) or to reduce the length of the exclusive dealing obligation.

2. Conditional rebates

While the assessment of exclusive dealing obligation is generally relatively straightforward, determining whether conditional rebates granted by dominant firms are anti-competitive and should be prohibited as abusive requires more complex evaluations.[151]

As we have seen in Part III, competition authorities and courts, particularly in the EU, but also in other jurisdictions, have often taken strict approaches to the assessment of rebates, in some cases opting for *per se* rules of illegality against certain types of rebates, such as, for instance, fidelity rebates. We have, however, seen that such per se rules are not in line with modern economic thinking and that there is a consensus among lawyers and economists that competition authorities should instead opt for an effects-based analysis based on price cost tests, an approach that has been adopted in many jurisdictions in recent years. Brazil is among these other jurisdictions, although its recent experience also shows a lack of substantive criteria to implement an effects based analysis.

In its Guidance Paper on Article 102, the European Commission articulated economic tests to assess single-product and multi-product (mixed bundling) rebates, which will be analyzed in this Section as they represent an interesting attempt to apply a rigorous, economic-based methodology to rebates. Comparable tests also frequently relied upon by US courts to distinguish pro-competitive rebates from anti-competitive ones.

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[150] Id.

[151] See Damien Geradin, "A Proposed Test for Separating Pro–competitive Conditional Rebates from Anti–competitive Ones" (2009) 32 *World Competition*, 41

Competition authorities and courts need to address three important questions to determine whether conditional rebates granted by dominant firms amount to anti-competitive abuses. The first question is whether the rebates in question foreclose equally efficient competitors from the dominant firm's customers. If the answer to this question is positive, the second question is whether the rebates represent a substantial share of the market to which equally efficient rivals can turn. If the answer to this question is positive, the third question is whether the foreclosure effects of the rebates can be compensated by the presence of efficiencies. These questions will be successively addressed by reference to the Guidance Paper, suggesting a substantive test to evaluate competitive effects of rebates.

2.1 Can the rebates foreclose equally-efficient competitors from the dominant firm's customers?

As a preliminary remark, it is important to note that one of the virtues of the Guidance Paper is that it seeks to move away from the terminology traditionally used by the Commission and the EU courts, which relied on concepts, such as fidelity rebates, quantity rebates or target rebates, towards the clearer notion of "conditional rebates", which it defines as "rebates granted to customers to reward them for a particular form of purchasing behaviour."[152] While the Guidance Paper acknowledges that conditional rebates are not an uncommon practice, it notes that such rebates – when granted by a dominant undertaking – can also have actual or potential foreclosure effects similar to exclusive purchasing obligations.[153]

a. Distinction between single- and multi-product rebates

For the purpose of assessing the potential foreclosure effects of conditional rebates, the Guidance Paper makes a distinction between single-product rebates (i.e., rebates applying to one product) and multi-product or bundled rebates (i.e., rebates applying across several products). The Guidance Paper discusses bundled rebates as part of its section on tying, but as such rebates raises issues analogous to single-product rebates, we will analyse them as part of this section.

Single-product rebates

The Guidance Paper details several factors that it considers to be of particular importance in determining whether a given system of conditional rebates is liable to result in anticompetitive foreclosure. The Guidance Paper indicates that anticompetitive foreclosure is more likely to occur where the dominant undertaking's rivals are not able to compete on equal terms for the entire demand of each individual customer. The reason is that a conditional rebate granted by a dominant undertaking may enable it to use the "non-contestable" portion of the demand of each customer (i.e. the amount that would anyhow be purchased by the customer from the dominant

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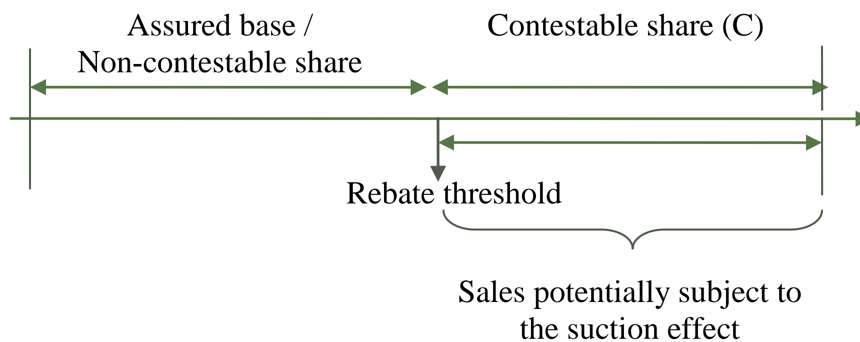
[152] Guidance Paper, supra note 7, at § 37.

[153] Id.

undertaking) as leverage to decrease the price to be paid for the "contestable" portion of demand (i.e. the amount for which the customer may prefer and be able to find substitutes).[154]

The concern expressed in the Guidance Paper can be illustrated as follows. Let us assume that a dominant supplier sells to a particular company. The supplier has an assured base of sales to that customer because, for a portion of the customer's demand, there are no proper substitutes.[155] These sales represent the non-contestable share of that company's demand. However, the portion of the customer's demand for which substitutes are available is the contestable share, of that customer's demand.[156] The dominant supplier offers the company a retroactive rebate. This gives the customer a rebate over all the quantities sourced if it purchases more than the rebate threshold level within the reference period.[157] This scenario is illustrated by the graph below.



The competition concern is that when the non-contestable part (*NC*) of the customer demand in question is large compared to the contestable part (*C*), i.e. when $NC > C$, the retroactive rebate may allow the dominant supplier to leverage its position of strength in the non-contestable to the contestable part of a customer's sales. Indeed, while the dominant supplier can recoup the rebate on its overall sales including both contestable and non-contestable parts (i.e. the dominant firm does not incur losses on the whole range of sales), competing suppliers will have to recoup the rebate over a smaller base represented by the contestable part. This retroactive rebate scheme could thus have the effect of excluding equally efficient rivals from that part of the customer's sales that would otherwise be contestable.

Echoing the position expressed by the EU courts, the Guidance Paper also notes that "retroactive" rebates may foreclose the market significantly, "as they may make it less attractive for customers to switch small amounts of demand to an alternative supplier, if this would lead to loss of the retroactive rebates."[158] In this respect, the higher the rebate as a percentage of the total

[154] Id. at § 39.

[155] See Discussion Paper, supra note 7, at § 143.

[156] *Id.* at § 153.

[157] *Id.* at § 152.

[158] Id., at § 40.

price (e.g., a 20 % rebate, which is a large rebate) and the higher the threshold (e.g., the fact that the 20% rebate would be granted when the buyer purchases more than 90% of its requirements from the dominant firm), the greater the inducement below the threshold (this indictment being sometimes referred to as the "suction effect"[159]) and, therefore, the stronger the likely foreclosure of actual or potential competitors.

The Guidance Paper provides that the Commission intends to investigate "to the extent that the data are available and reliable" whether the rebate granted by the dominant firm is capable of hindering the expansion or entry even of "as efficient" competitors by making it more difficult for them to supply part of the requirements of individual customers.[160]

The Commission will estimate what price a rival would have to offer to the buyer that has received a conditional rebate from a dominant firm in order to compensate this buyer for the loss of that rebate if the latter would switch part of its demand, which is referred to as the "relevant range", away from the dominant undertaking. The price that the competitor will have to match is not the average price of the dominant undertaking, but the normal (list) price less the rebate it loses by switching (i.e., the "effective price"), calculated over the relevant range of sales and in the relevant period of time.

The Guidance Paper provides that for incremental rebates, the "relevant range" is normally the incremental purchases (i.e., the purchases made beyond the threshold set by the dominant firm for granting the rebate) that are being considered. For retroactive rebates, it will generally be relevant to assess in the specific market context how much of a customer's purchase requirements can realistically be switched to a rival (the "contestable share" or "contestable portion").

Against this background, the Guidance Paper provides that:

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[159] Discussion Paper, supra note 74, at § 153.

[160] Guidance Paper, supra note 7, at § 41. According to this standard, as long as a dominant firm sells its products at an effective price (standard price minus the rebate it grants to its customers) that is above a certain measure of its costs, the rebate in question should be legal even if it has the effect of eliminating weaker competitors. Tests which would rely on competitors' costs or any other benchmark exceeding the dominant firm's own costs would protect less efficient competitors and ultimately deprive consumers of the beneficial effects of price competition. Such tests would also generate a significant degree of uncertainty as it would be impossible for a dominant firm to know in advance whether its rebates would be illegal. While dominant firms obviously know their cost structure, they are in no position to know the costs of their competitors and thus could not self-assess their pricing practices. This aspect was recently emphasised by the GC in *Deutsche Telecom* in which the Commission had applied the "as efficient competitor" test. The Court condoned this test, holding that any other approach would be contrary to the general principle of legal certainty. See GC, *Deutsche Telecom v. Commission*, T-271/03, [2008] ECR II-477, at § 192. A similar approach prevails in US antitrust law as made clear by a US federal court in *Ortho Diagnostic Systems, Inc. v. Abbott Labs.*, 920 F. Supp. 455 (S.D.N.Y. 1996), which held that: "only price cutting that threatens equally or more efficient competitors is condemned under Section 2. Any other rule would entail too substantial a risk that the antitrust laws would be used to protect an inefficient competitor against price competition that would afford substantial benefits to consumers." *Id.* at 469-470.

- Where the effective price remains consistently above the long run average incremental cost (LRAIC) of the dominant undertaking, this would normally allow an equally efficient competitor to compete profitably notwithstanding the rebate. In those circumstances the rebate is normally not capable of foreclosing in an anti-competitive way.

- Where the effective price is below average avoidable cost (AAC), as a general rule the rebate scheme is capable of foreclosing even as efficient competitors.

- Where the effective price is between AAC and LRAIC, the Commission will investigate whether other factors point to the conclusion that entry or expansion even by as efficient competitors is likely to be affected. In such a case, the Commission will investigate whether and to what extent rivals have realistic and effective "counterstrategies" at their disposal, for instance their capacity to also use a "non-contestable" portion of their buyer's demand as leverage to decrease the price for the relevant range.[161]

A simple numerical example can be used to clarify the leverage mechanism described by the Commission in the *Guidance Paper*. Suppose that Customer *A* will always buy *50 Units* that are available only from the dominant supplier, so the assured base or the non-contestable share $Q^{A}_{NCS} = 50$ *Units*. But the customer's total demand $Q^{A}_{T} = 100$ *Units,* and the remaining *50 Units* could be satisfied by products sold by either the dominant supplier or one of its competitors. Thus the contestable share $Q^{A}_{CS} = 50$ *Units*. The *AAC = 1 $/Unit.* The *LRAIC = 2 $/Unit.*

The dominant supplier offers the following pricing scheme. The customer pays *4 $/Unit* if it buys any quantity less than 100 units. So $P_{Before\ Rebate} = 4$ *$/Unit if Q < 100 Units.* But if the customer buys 100 units *(Q = 100 Units)* it receives a rebate *R* worth $ 120 in total, or *1.2 $* for each of the 100 units bought in total. $P_{After\ Rebate} = 2.8$ *$/Unit if Q = 100 Units.* To determine whether there is a suction effect, the Guidance Paper requires the calculation of the effective price, P_e, for the units that belong to the contestable share and see whether this price is inferior to the dominant supplier's LRAIC.

$P_{Before\ Rebate} = 4$ *$/Unit*
$P_{After\ Rebate} = 2.8$ *$/Unit = 4$/Unit – 1.2 $/Unit*
Contestable share C = 50 Units
→$Total_{With\ rebate} = 100 \times 2.80$ *$ = 280 $*
→$Total_{Without\ rebate} = 50 \times 4$ *$ = 200 $*
$Total_{With\ rebate} - Total_{Without\ rebate} = 280$ *$ - 200 $ = 80 $ is being paid for the last 50 contestable units*
The effective price (P_e) *over the last 50 = 80 $ / 50 = 1.6 $*
As $AAC < P_e < LRAIC$ → *the Commission will look at whether the dominant firm's rivals have counterstrategies*

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[161] Guidance Paper, supra note 7, at § 44

Among the factors taken into consideration by the Commission in its assessment is whether the threshold set by the dominant firm is "individualized" or "standard". The importance of this distinction comes from the fact that while an "individualised" threshold allows the dominant supplier to set the threshold at such a level as to make it difficult for customers to switch suppliers, a standardised volume threshold may be too high for some smaller customers and/or too low for larger customers to have a loyalty enhancing effect[162]. The loyalty-inducing effect is thus likely stronger for individualised thresholds than standard ones.

Bundled rebates

In a multi-product rebate setting, a dominant supplier might be assured of a certain level of sales from a customer if that customer's demand is spread across several different products, and the dominant supplier is the only company able to offer some of those products.[163] In this case, a multi-product scheme can work in the same way as a single product one – to leverage the dominant company's position of strength in the assured base into the contestable part of a customer's sales.

The test proposed by the Commission in its Guidance Paper is that:

> "If the incremental price that customers pay for each of the dominant undertaking's products in the bundle remains above the LRAIC of the dominant firm from including this product in the bundle, the Commission will normally not intervene since an equally efficient competitor with only one product should in principle be able to compete profitably against the bundle. Enforcement action may however be warranted if the incremental price is below the LRAIC, because in such a case even an equally efficient competitor may be prevented from expanding or entering."[164]

This test can here again be illustrated through a simple numerical example. Assume that the dominant supplier sells two products, *X* and *Y*. *Product X* is only offered by the dominant supplier, but *Product Y* is offered by both the dominant supplier and some efficient rivals. *Customer A* will always buy *50 units of product X* from the dominant supplier, so this supplier has an assured base of 50 units ($Q_{\mathbf{X}}{}^{A}{}_{NCS} = 50$ *Units).* But the customer also has a demand for *50 units of product Y* ($Q_{\mathbf{Y}}{}^{A}{}_{CS} = 50$ *Units)*, and these sales could be contested by efficient entrants or rivals, so there is a contestable market of 50 units. The *LRAIC* of producing one unit of X and Y is similar, i.e. *2 $*.

[162] Id. at § 45.

[163] See Guidance Paper, at § 60 ("If the evidence suggests that competitors to the dominant undertaking are selling identical bundles, or could do so in a timely way without being deterred by possible additional costs, the Commission will generally regard this as bundle competing against a bundle, in which case the relevant question is not whether the incremental revenue covers the incremental costs for each product in the bundle, but rather whether the price of the bundle as a whole is predatory.")

[164] See Guidance Paper, supra note 7, at § 60.

The dominant supplier offers the following multi-product rebate scheme. The customer pays *4 $/Unit* for either product if they buy any aggregate quantity less than *100 units.* So $P_{Before\ Rebate}$ = *4 $/Unit if Q < 100 Units.* But if they buy *100 units* they are given a rebate worth *120 $* in total, or *1.2 $/Unit* for each of the *100 units* bought in total. So $P_{After\ Rebate}$= *2.8 $/Unit if Q = 100 Units.* As the methodology and the figures are the same as in the example used above, the result will be the same. The effective price (P_e) over the 50 contestable units of *product Y = 80 $ / 50 = 1.6 $.* As $P_e < LRAIC$, the rebate may create exclude equally efficient rivals.

b. Assessment of the effects-based approach of the Guidance Paper

While the logic of the suction effect test proposed by the Commission is attractive and such a price-cost test represents a major progress compared to the formalistic approach pursed by the EU Courts, this test raises a number of implementation issues that are discussed below.

The most significant difficulty raised by the suction effect test relates to the determination of the size of the contestable share of a given customer's demand.[165] The suction effect test relies on the assumption that the dominant supplier controls a part of the demand of the customer to which it gives a rebate (or, in the case of multi-product rebates, the dominant supplier sells a product needed by the customer in question and for which there is no alternative supplier), which will be its assured base. It also assumes that this assured base (and thus the non-contestable part of the customer's demand) is large (as otherwise, the dominant firm would not be able to leverage its control of the non-contestable part to the contestable part).[166]

The test is quite intuitive for multi-product rebates, where it is easy to distinguish between the competitive and non-competitive products since they are distinct. As far as single-product rebates are concerned, it can by contrast be difficult to determine in practice whether – and, if so, the extent to which – the demand of a given customer for a particular product or service is contestable. Several factors should play a role in this determination: (i) *switching costs*: when such costs are significant, they may have the effect of locking-in customers with the dominant supplier even if they were willing to switch part of their requirements to alternative suppliers. The contestable share will thus be small; (ii) *must-have brands (or must-stock products)*: some brands or products may be essential for various categories of retailer;[167](iii) *capacity constraints*:

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[165] In its submission to the OECD Roundtable on rebates, the OFT stated: "While sound in theory, perhaps the most difficult aspect of applying the [suction effect] test is assessing what proportion of a customer's purchases are in practice 'assured' as opposed to 'contestable.'" United Kingdom, Roundtable on Bundled and Conditional Discounts and Rebates, DAF/COMP/WP3/WD(2008)46, 10 June 2008 at § 38.

[166] See Discussion Paper supra note 74, at § 146 :"In markets where for all or most part of demand there are proper substitutes, for instance where the product is homogeneous and the competitors to the allegedly dominant company are not capacity constrained, rebate systems will generally not have a market distorting foreclosure effect. If competitors are competing on equal terms for all the customers and for each individual customer's entire demand, then a rebate system is unlikely to have a foreclosure effect unless the effective price under the rebate system, calculated over all sales by the dominant company to its customer(s), is found to be predatory …"

[167] For instance, supermarkets may have to stock certain popular consumer brands, such as for instance Coca Cola, Danone or Nestlé and consumer electronics' retailers may have to stock leading brands, such as Apple, LG, Samsung or Sony. With limited exceptions, brands trend to play a lesser role in input markets, such as for instance (continued…)

even if customers were willing and able to switch to alternative suppliers, such suppliers may be unable to satisfy the resulting demand, hence ensuring an assured base to the dominant firm (at least equal to the total demand minus the maximum available capacities of its rivals); and (iv) *single-source supply*: in sectors where transaction costs savings are of critical importance, customers may prefer to buy from a single supplier that is able to supply them with the full, or at least a large part, of the range of the products they need. This may prevent suppliers with a narrow range of products from supplying such customers.[168]

The problem is that these different factors, and their relative importance for a given product/service and/or a given customer, are hard to measure. The difficulty of determining the contestable share of a given customer's demand may thus make the application of the suction effect test proposed by the Commission quite difficult in practice.

c. Proposed alternative approach

When it is not possible to establish with a sufficient degree of certainty the size of the contestable part of a given customer's demand, the best approach is probably – as it is the case of unconditional or conditional incremental rebates – to apply a classic predation test over *all* the units sold by the dominant firm. This approach is supported by Professor Hovenkamp in its leading antitrust treatise on the ground that other tests may be hard to administer and risk chilling price competition.[169]

Some may argue that a predation test is insufficient to identify the potential anticompetitive effects of retroactive rebates, and thus create a risk of Type II errors.[170] But this will only be true when the strict assumptions (including the fact that *NC*>*C*) adopted in the Discussion Paper and Guidance Paper are present, and when the dominant firm's competitors have no counter-strategies to overcome the handicaps that may prevent them from contesting a part of *NC*. Moreover, as will be seen below, the cost standard test proposed by the Commission in the *Discussion Paper* (*ATC*) or the *Guidance Paper* (*LRAIC*) is particularly stringent and certainly more stringent than the cost standards recommended by the majority of scholars and practitioners (*AVC* or *AAC*).[171] Thus, reliance on a demanding cost standard may be a way of reducing the risk

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raw materials or electronic components, as these inputs will be embedded in products and thus not directly identifiable by the end consumers.

[168] Note, however, that a supplier that is unable to supply the full range of products required by a given customer, can try to team up with other suppliers producing the products missing from its products range so as to jointly offer the product range needed.

[169] Philip E. Areeda and Herbert Hovenkamp, *Antitrust Law* (Supp. 2007) § 749b, at 245.

[170] See, e.g., Robert H. Lande, "Should Predatory Pricing Rules Immunize Exclusionary Discounts?", (2006) *Utah Law Review* 863, 878.

[171] The *Discussion Paper* justifies the use of a long run cost standard such as *ATC* (and implicitly *LRAIC*) by saying that a company can fund losses on sales in the contestable part of demand through profits on sales in its assured base, and so can operate a rebate scheme for a long time. See *Discussion Paper*, supra note 74, at § 154. This reasoning, however, fails to convince most legal and economic scholars, who instead believe that *AAC* is the right cost standard. See, e.g., Simon Bishop and Philip Marsden, "Editorial - The Article 82 Discussion Paper: A Missed

(continued…)

of false negatives that – it is alleged – may result from the application of a pure predation test to retroactive rebates.

One way to reduce the risk of Type II errors is to combine the standard predation test with an analysis of a series of market factors. In this respect, the Commission suggests in the 2005*Discussion Paper* on Article 102 that:

> "Where it is in general not possible to accurately establish the [contestable] share, the Commission will overall assess to what extent the rebate system hinders expansion or entry by competitors. It will do so by investigating the market performance of the dominant company and its competitors, preferably by comparing the situation before and after the rebate system was introduced. It will amongst others estimate the importance of the rebate by comparing its size to the full price per unit of product and will assess the indications of an actual foreclosure effect such as exit or declining market shares of competitors or de-listing of their products."[172]

The section of the Guidance Paper dealing with rebates no longer mentions these factors referred to in the above abstracts. However, in its general section on foreclosure, the Guidance Paper states that a number of factors will be taken into account to determine when an alleged abusive conduct is likely to lead to anti-competitive effects, including

> "*possible evidence of actual foreclosure*. If the conduct has been in place for a sufficient period of time, the market performance of the dominant firm and its competitors may provide direct evidence about anticompetitive foreclosure; for reasons attributable to the allegedly abusive conduct, the market share of the dominant firm may have risen or a decline in market share may have been slowed; for similar reasons, actual competitors may have been marginalised or may have exited, or potential competitors may have tried to enter and failed."[173]

Opportunity", April 2006, *European Competition Journal*, 1-7 at p.5. First, as long as it covers its *AAC*, it makes economic sense for the dominant firm to make the sale, as any additional revenue will make a positive contribution to recovering fixed costs, which is a prime concern for most firms. Accordingly, pricing behaviour whereby a firm sells part or even all of its output at prices below *ATC*/*LRAIC* is a pervasive practice, in particular in sectors where firms incur high fixed costs (i.e. network industries, research-intensive sectors, etc.). Thus, prices below *ATC* but above *AAC* may be perfectly rational conduct and should thus not raise antitrust scrutiny. Second, the fact that a rebate scheme *can* be operated for a long time cannot justify assuming that it *will* be operated for a long time. Dominant firms may *temporarily* price below both *ATC* and *LRAIC* for a number of legitimate reasons, for example because they want to promote a new product through a relatively low initial entry price (so-called "penetration pricing"), because there is a sudden drop in demand, because the company is operating in the early stages of a market with switching costs and so on. When low prices are only temporary, costs that vary only in the long run cannot be avoided and thus should not be included when assessing whether the prices are profitable. Moreover, whether it is true that a firm can fund losses on sales in the contestable part of demand through profits on sales in its assured base, this strategy will nevertheless have a cost (in terms of foregone profits) that the dominant firm may not necessarily want to carry for a long period of time.

[172] See *Discussion Paper*, supra note 74, at § 164.

[173] See Guidance Paper, supra note 7, at § 20.

While the willingness of the Commission to look at the "effects" of conditional rebates granted by a dominant firm should be welcomed, the analysis of the market factors enumerated in the above quotes should be handled with care. It might indeed be tempting for a competition authority to look at the respective market shares of the dominant firm and its rivals *before* and *after* the rebate system was introduced and, if the market share of the dominant firm has increased while those of its rivals have decreased during the relevant period, conclude that this must be due to the foreclosure effects of the rebates in question, hence prohibiting them. This approach would be much too simplistic, however, as market share fluctuations may be due to a wide range of factors, such as the fact that the dominant firm's products have increased in quality while those of its rivals have decreased in quality, changes in consumer demand unrelated to the rebates granted, and other such changes which may be hard to measure. The *causality* between the rebates granted by the dominant supplier and the decrease (or simple maintenance) of the market shares of its rivals could thus not be clearly established.[174]

When rebates have been granted for a certain period of time, a more relevant approach would be to look at whether the very objectives of exclusionary pricing have been achieved. The rationale of this approach is that the reason why dominant firms may seek to exclude competitors through anti-competitive rebates is to subsequently increase prices (or decrease output), reduce quality, or slow down the innovation race.[175] Thus, when these effects have not occurred, it cannot be concluded that consumers have been harmed. If anything, price decreases at constant (or even improved) quality level show that the rebates in question are, as is usually the case, pro-competitive and enhance consumer welfare. Indeed, in a context of continuous price decreases, rebates are likely to be just additional evidence of fierce competition. In these cases, it may be just as important to avoid Type I errors (over-deterrence) than Type II errors (under-deterrence), taking a very careful approach when characterizing a particular rebate system as anticompetitive.

2.2 Do the foreclosed customers represent a significant share of the relevant market?

Price-cost tests are useful instruments to determine whether the rebates in question *can* foreclose competitors because the dominant firm's customers cannot turn to alternative suppliers without incurring substantial switching costs, which equally efficient competitors cannot overcome. But the fact that a given rebate regime fails the price-cost test cannot be the end of the inquiry.

The next stage in the inquiry is to determine whether these customers represent a substantial share of the market to which such rivals can turn, depriving them of the possibility to profitably

[174] The same is obviously true with respect to rivals' exit. Dominant firms' competitors may be forced from the market for a variety of reasons unrelated to the rebates in question, such as high prices, poor quality of products, bad management, lack of proper marketing, etc. Measuring the actual impact of the rebates on market outcomes that may also result from a range of other factors is likely to be a very hard task.

[175] These market outcomes are usually easy to identify and well within the reach of a sophisticated competition authority.

expand and/or enter.[176] The fact that a given rebate forecloses one or several competitors of the dominant firm from supplying one or several customers is not sufficient to demonstrate the presence of anti-competitive effects. Such effects will only appear when such customers represent a substantial share of the market that is critical for rivals' competitiveness. Otherwise, even if they are unable to supply one or several customers, rivals will have access to a sufficient share of the demand for the products/services in question to allow them to profitably enter or remain on the market, and thus constrain the dominant firm.[177] This central point was made by Philip Lowe, the then Director General of DG COMP, in relation to the Discussion Paper:

> "In the [Discussion Paper] we propose that for rebates – as well as for other types of price based conduct – the exclusion of "as efficient competitors" is abusive. Though this is not the only test which can be used to show abuse, it is a useful one, as it allows dominant firms to assess their conduct based on their own costs. A failed price-cost test is of course not the end of the analysis. We would still have to show a likely market foreclosure effect."[178]

The question is of course to determine what a "substantial" share or amount of the market is, in order to establish the level of foreclosure that should raise concerns to competition authorities. As noted above, the answer to this question is bound to vary from one market to the other and thus requires a case-by-case analysis. For instance, in markets with a small minimum efficient scale (MES) and generally low barriers to entry, rebates that cover a relatively large portion of the market may be insufficient to hinder new entrance.

2.3 Are the rebates' anti-competitive effects counterbalanced by the efficiencies?

If the rebates in question foreclose a substantial share of the market, the dominant firm should be allowed to demonstrate that the foreclosure effects of the rebates are offset by pro-competitive efficiencies.

While the importance of efficiencies has long been recognized by US courts, one of the criticisms often made against the decisions of the Commission and the EU Courts was that they failed to sufficiently consider the rebates' actual or potential efficiencies, focusing too much

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[176] For an application of this standard in US law, see Concord Boat, 207 F.3d at 1059 (the court noting that the boat builders had "failed to produce sufficient evidence to demonstrate that Brunswick had foreclosed a substantial share of the stern drive engine market through anticompetitive conduct.")

[177] Note that in sectors where economies of scale and scope are small and network externalities irrelevant, a rebate that forecloses a substantial share of the market may not, in itself, be capable of driving out competitors, and thus must be deemed lawful. See "Comments of Professor Elhauge on DG Competition Discussion Paper on Exclusionary Abuses", at p. 3, available at http://ec.europa.eu/comm/competition/antitrust/art82/072.pdf

[178] Philip Lowe, "Remarks on Unilateral Conduct", Session on International Enforcement Perspectives, Federal Trade Commission and Antitrust Division Hearings on Section 2 of the Sherman Act, Washington DC, 11 September 2006 (emphasis added).

instead on their actual or potential exclusionary effects.[179] The more recent case law of the EU Courts, as well as the Commission's Guidance Paper signal the importance of taking efficiencies into account in the assessment of rebates.[180]

The Guidance Paper indicates that the Commission will be willing to consider "claims by dominant undertakings that rebate systems achieve cost or other advantages which are passed on to customers."[181] The Guidance Paper is, however, rather cryptic as to the categories of cost advantages that will be accepted by the Commission, merely providing that transaction related cost advantages are often more likely to be achieved with standardised volume targets than with individualised ones. As to other efficiencies, the Guidance Paper limits itself to noting that incremental rebates are generally more likely to give resellers an incentive to produce and resell a higher volume than retroactive rebate schemes without, however, explaining why this is the case.[182]The Guidance Paper would have benefited from a broader review of the various "efficiencies" or pro-competitive effects that are associated with rebates, which we discussed in Part II above.

As noted above, one important aspect in the assessment of conditional rebates is to analyse the possible pro- and anti-competitive effects of a given rebate regime with an open mind rather than based on views that certain type of rebates can only harm consumers. For instance, "fidelity" or "market share" rebates, which are often seen negatively by competition authorities and courts, can be a source of efficiencies.[183] Market-share rebates may indeed be needed to reach objectives that cannot be achieved through volume-based rebates. While volume-rebates tend to incentivize buyers to buy larger quantities (hence allowing the supplier to achieve economies of scale, etc.), they may represent a risk for buyers in industries where it is hard to predict in advance how a given line of products will sell. In such industries, customers may indeed fail to obtain the rebate at the end of the period for reasons that may be independent of their will and efforts. Customers may thus ask suppliers for a market-share rebate since they ensure customers will collect the rebate by purchasing their requirements up to the percentage level needed to reach the threshold. Hence, percentage-based rebates amount to a risk-sharing mechanism between the suppliers and their customers.

When demand is uncertain, risks can also be shared between suppliers and customers through the adoption of a retroactive rebate. Rather than setting in advance the price and the volume of the

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[179] See Damien Geradin, "Efficiency Claims in EC competition Law and Sector-specific Regulation" in H. Ullrich, Ed., *The Evolution Of European Competition Law Whose Regulation, Which Competition?*, Edward Elgar, 2006.

[180] "Lately there has been a shift in the Commission's and the European Courts' practice which, more clearly than in the past, ensures that efficiencies are taken into account by allowing the dominant firm to show that the efficiencies are likely to outweigh the anti-competitive effects to the benefit of consumers." See, e.g., European Commission, Roundtable on Bundled and Conditional Discounts and Rebates; DAF/COMP/WP3/WD(2008)48.

[181] Id. at § 46.

[182] Id.

[183] Efficiencies may also be hard to prove, especially when a given rebate is not motivated by a particular reason but reflects the competing views of multiple executives involved in commercial negotiations.

products to be purchased (which guarantees volumes to the supplier, but places a lot of pressure on the buyer), the supplier and the buyer may agree that a retroactive rebate will be granted above a certain threshold. The supplier knows that the buyer will have a strong financial incentive to meet the threshold (which should in turn guarantee some volumes to the supplier), but the buyer will not be forced to meet the threshold on pain of breaching its contractual obligations. In the worst case scenario, failing to meet the threshold will only translate in not obtaining the rebate and thus suffering a price penalty.

In sum, in order to truly implement an effects-based approach, grounded on modern economic theory (as described above), competition authorities should take potential efficiencies of rebates seriously, evaluating them in detail, and not just considering them as an exception to what would otherwise be an exclusionary conduct.

3. Tying

Tying is a common commercial practice relied on by dominant and non-dominant firms. Tying often increases the value of products to users.[184] Smartphone and tablet sales are, for instance, growing fast because these devices integrate multiple features. They combine mobility and computing power, and the thousands of applications they offer attract users. Prohibiting tying under *per se* rules does not make any sense, and in many instances is likely to hurt competition and harm consumers.

As seen in Part II, the economic analysis of tying has gone through different phases and now seems to have a reached an equilibrium whereby most economists agree that while tying is generally pro-competitive there may be circumstances where it produces foreclosure effects. That is the line taken by the European Commission in its Guidance Paper. Because tying should not be subject to *per se* rules of illegality (or legality), it is critical to develop the right analytical test to help competition authorities and courts separate pro-competitive rebates from anti-competitive ones.

In practice, the following conditions should be met for declaring a given tying conduct illegal: (i) the tying and the tied products should be distinct; (ii) dominance in the tying market; (iii) the tying conduct should produce anti-competitive foreclosure; and (iv) it is not justified by countervailing efficiencies. The rest of this section reviews these conditions, before drawing some conclusions.

3.1 The tying and the tied products should be distinct

According to the case-law of the EU courts, two products are distinct if there is separate demand for the tied product. Thus, in its *Microsoft* judgment, the GC found that Windows and Windows Media Player were distinct products as there is separate demand for media players. Taken literally, this “separate demand for the tied product” test might lead one to conclude that mobile

[184] Elhauge and Geradin, supra note 3, at 570.

telephones and ring tones, PCs and keyboards, and MP3 players and earphones are all distinct products, despite the fact that consumers clearly see them as forming part of a single product. This test thus creates a considerable risk that perfectly benign combination of products be caught as anti-competitive (a Type I error).

The correct test is that two products are distinct if there is no separate consumer demand for both the tying *and* the tied product. Indeed, it is perfectly possible for there to be separate demand for ring tones without a mobile phone, but there is surely no demand for a mobile phone without a ring tone. Similarly, while there is separate demand for laces, there is obviously no demand for shoes without laces. By contrast, while printers and paper are typically used together, there is separate demand for both the printer (in this case the tying product) and the paper (the tied product). An attempt by dominant printer manufacturer to tie the sale of its printers to the purchase of large quantities of paper would thus meet this second condition of the test.

In its Guidance Paper, the Commission seems to follow that line of reasoning when it says that:

> "Two products are distinct if, in the absence of tying or bundling, a substantial number of customers would purchase or would have purchased the tying product without also buying the tied product from the same supplier, thereby allowing stand-alone production for both the tying and the tied product."[185]

3.2 Dominance in the tying market

As we have seen in Part II, tying may be used to leverage a dominant position in the tying product market to the tied product market. It must therefore be demonstrated that the firm that engages in tying is dominant on the tying product market, otherwise it will not be able to impose the joint sale of the tied product. Indeed, in a context where the firm does not have a dominant position in the tying product, attempting to impose a joint sale the tied product will just drive consumers that are unwilling to buy de package to other suppliers that offer the two products separately.

3.3 Anti-competitive foreclosure

As we have discussed in Part II, tying may be used for both "offensive" and "defensive" leveraging purposes.[186]

a. Offensive leveraging

For the reasons described above, applying *per se* rules of illegality (or legality) to tying does not make sense as tying can be source of significant efficiencies, which may more than compensate the anti-competitive effects that may be produced by such conduct. But even before the

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[185] Guidance Paper, supra note 7, at § 51.

[186] Id. at § 52.

competition authority or the court engages in that balancing (see section 3.4 below), they must establish that the conduct in question is likely to create anti-competitive effects. Several observations should be made in that respect.

First, competition authorities and courts should not rush to the conclusion that tying forecloses rivals on the tied product market. This essentially depends on the circumstances and, in particular the extent to which, rivals can develop "counterstrategies" to compete on the tied product market. For instance, if a customer cannot acquire a printer (the tying product) without buying a large quantity of paper (the tied product) from the printer manufacturer, that customer will not purchase paper from the manufacturers' competitors, at least for a certain period of time. In these circumstances, the customer is clearly "coerced" to buy the dominant firm's paper and rival paper makers are foreclosed. In contrast, by selling Internet Explorer as part of its Windows operating system, Microsoft does not necessarily foreclose other browser developers. While printer users that are forced to buy large quantities of paper will not buy additional paper from other suppliers, nothing prevents computer users from having different browsers on their computer (a practice called "*multi-homing*"), especially if competing browsers can be easily downloaded from the web. Thus, by developing a two-sided business model allowing them to offer their browser for free and making their browser easily downloadable from the web, rival browser makers manage to compete, and succeed, on the tied product market. This explains why despite the fact that Internet Explorer comes together with Windows, many computer users use rival browsers, such as Firefox or Chrome.

Second, to support their foreclosure analysis, competition authorities and courts can use different economic techniques, such as, for instance, "counterfactual analysis". For instance, in its Guidance Paper, the European Commission provides that when pursuing a case it will usually compare:

> "the actual or likely future situation in the relevant market (with the dominant undertaking's conduct in place) with an appropriate counterfactual, such as the simple absence of the conduct in question or with another realistic alternative scenario, having regard to established business practices."[187]

When the information is available, the competition authorities or courts can, for instance, compare the situation in markets where the dominant firm engaged in tying with the situation in markets where it did not engage in tying. That generally allows having a better view on the impact of tying on competition.

Third, as in the case of exclusive dealing and rebates, tying can only foreclose rivals if it applies to a substantial share of the market. For instance, a dominant firm engaging in contractual tying with a number of customers representing a small share of the overall demand for the tied product is unlikely to create foreclosure effects as the contestable share of the tied product market will remain sufficient to allow them to trade profitably.

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[187] Guidance Paper, supra note 7, at § 21.

b. Defensive leveraging

While there may be circumstances where tying may be used by a dominant firm to protect its market power in the tying market, defensive leveraging claims should be analysed very carefully as they are often based on speculative reasoning. As we have seen above, in the 1990s, the US DoJ alleged that by tying its Internet Explorer browser to Windows, Microsoft was trying to eliminate Netscape (Internet Explorer's main rival) as Microsoft was concerned that Netscape could eventually challenge its dominant position in the PC operating system market.

3.4 Efficiencies

As we have seen above, tying can be a source of significant efficiencies. This view is shared by the European Commission, which in its Guidance Paper states that it will look into claims by dominant undertakings that their tying and bundling practices may lead to cost savings benefiting customers, reduce transaction costs for customers, or that combining two independent products into a new, single product might enhance the ability to bring such a product to the market to the benefit of consumers.[188]

Balancing potential anti-competitive effects with potential efficiencies is a critically-important task for competition authorities and courts. The reason is that while tying can have a very serious negative impact on rivals and thus produce foreclosure effects, it may not harm consumer welfare. In many instances, consumers significantly benefit from the integration of products that were previously sold separately. In the modern economy, product integration is one of the ways manufacturers seek to increase the value proposition they offer to their consumers, and different value propositions may be considered an important dimension of competition.

Conclusion. Taking the EU Commission Guidance Paper as a starting point, this section developed an analytical framework to deal with the difficulties of identifying vertical restraints that should be considered antitrust violations. The proposed principles and guidelines attempt to design brighter standards to define infringements under the vague language of competition laws in the EU, Brazil and probably elsewhere. By doing so, the ultimate goal is to reach a more efficient level of enforcement, avoiding type 1 ("false positive") and type 2 ("false negative") errors with their respective consequences of over and under deterrence.

VII. Necessary Institutional Background for Implementing the Proposed Analytic Framework

Developing an analytical framework for evaluating competitive effects of vertical restraints is one step in the direction of a more efficient level of enforcement. However, the actual implementation of such a framework will generally depend on the institutional endowment of the relevant jurisdiction (competition authorities, courts, antitrust bar, etc.). In other words, efficient

[188] Id. at § 62.

enforcement can only be reached where adequate substantive standards are matched by the right institutional capabilities.

In this context, it is important to shift our attention to the institutional challenges associated with the implementation of the proposed analytical framework. This section first analyzes these challenges at a more general level, pointing to the overall institutional capabilities required to implement an effects-based analysis of vertical restraints. Then, it discusses the institutional backgrounds of the EU and Brazil from a closer perspective, illustrating concrete challenges in these two important jurisdictions.

First, a key issue is to adjust the regulatory framework in order to allow the authorities to implement an effects-based approach. In most non-Anglo Saxon jurisdictions, this may involve legislative changes requiring explicit intervention from Congress or the relevant authorities. Such changes will, however, require the persuasion of the larger political community of the significant benefits of a flexible effects-based approach towards vertical restraints, which prevents harm to consumers while allowing businesses to develop more efficient ways to produce and distribute goods and services.

Second, once the legislative framework is in place, attention should turn to regulations capable of translating the general effects-based approach into workable standards to evaluate specific conduct. Competition authorities thus face the challenge of developing detailed guidelines to analyze vertical restraints. Such guidelines are desirable not only to improve the enforcement of competition rules, but also to send the right signals to market players. To the extent that they are clear and specific, such guidelines can become an important source of reference for compliance programmes developed by dominant undertakings. Providing consistent standards, safe harbours (e.g. safe harbour for levels of foreclosure that will not generate anticompetitive concerns), and circumstances that might increase the level of concern is crucial for improving enforcement under an effects-based system such as the one proposed in this report.

Third, considering that the analytical framework proposed above is heavily based on economic reasoning, it is important to ensure that competition authorities will have the institutional capacity to implement this analysis. This requires a multidisciplinary commitment from these authorities, which will have to apply legal and economic reasoning in an integrated manner. In practice, this means that both lawyers and economists in the authority should work side by side. Recruitment of officials with dual training in law and economics is also desirable.

In some authorities, implementing a more sophisticated analytical framework may also require the hiring of additional staff. Indeed, improving deterrence levels with effect-based analysis certainly requires more time and man power than applying a more simplistic form-based approach. Although the recruitment of additional staff is always a difficult process in any bureaucracy as it requires a greater budget, it should nevertheless be seen as an investment in better functioning markets, which will in turn bring important dividends to the national economy.

Fourth, as courts will probably have the final word on antitrust decisions, it is important that courts have the necessary capability to review decisions based on economic reasoning. The extension of this capability depends on the depth and breadth of judicial review of antitrust

decisions: the deeper the review, the more extensive economic reasoning will be necessary. In this context, procedural rules allowing for participation of economic experts and the weight of expert testimony will certainly influence the ability of courts to issue robust decisions on antitrust matters.

Finally, in order to implement a more complex effects based analysis, it is essential for the larger antitrust community to be technically prepared for the development of detailed legal and economic analysis. Indeed, external lawyers, economists and in-house counsel must be able to comprehend, develop and respond to complex legal and economic arguments in order to reach robust outcomes. Otherwise, it will not be possible to develop the sort of in-depth analysis required in the proposed framework.

As outlined above, in order to implement the analytical framework proposed in this paper, it is important to develop an institutional system, with rules, guidelines, robust analytic capabilities by the authorities, and well-prepared lawyers and economists on the ground. The next two sub-topics will discuss in more detail how the EU and Brazil can face this challenge.

A. The EU Institutional Background

As seen above, vertical restraints adopted by dominant firms are to be assessed under Article 102 TFEU, which is a broad provision designed to catch all types of abuses of dominance. Article 102, as it applies to vertical restraints, has been interpreted by the EU courts in a number of landmark judgments. In its 2008 Guidance Paper, the Commission has also expressed its priorities with respect to the enforcement of Article 102. There is therefore no need to introduce amendments to the TFEU or the adoption of interpretative guidelines to allow an effects-based approach to the assessment of vertical restraints adopted by dominant firms.

As far as the institutions in charge of enforcing EU competition rules are concerned, the EU system combines centralized and decentralized elements.[189] Cases presenting a so-called "Community interest" because they, for instance, involve conduct spanning across several Member States or novel issues of competition law, will be dealt with by the European Commission, whereas other cases will be handled by the national competition authorities ("NCAs").[190] Because Article 102 has so-called "direct effect",[191] it can also be applied by national courts either on their own motion or when it is invoked by the parties. The General Court in Luxembourg hears appeals lodged against Commission decisions, and the European

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[189] See Damien Geradin, "Competition between Rules and Rules of Competition: A Legal and Economic Analysis of the Proposed Modernization of the Enforcement of EC Competition Law", 9 (2002) *Columbia Journal of European Law,* 1

[190] Commission Notice on cooperation within the Network of Competition Authorities, O.J. 2004, C 101/43, at §15.

[191] Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, O.J. L 1/1, at §4.

Court of Justice hears appeals lodged against General Court judgments or questions of legal interpretation raised by national courts.[192]

As far as the European level is concerned, DG Competition, the General Directorate in charge of enforcing EU competition rules is a sophisticated institution that is perfectly capable of applying complex analytical frameworks. In its assessment of anti-competitive agreements and mergers, the Commission has, for the last two decades, relied on economic reasoning, and its 2008 Guidance Paper suggests that the assessment of conduct by dominant firms should also be based on economic analysis. While the majority of Commission officials are lawyers, DG Competition comprises an important number of economists, as well as a Chief Economist that is supported by over twenty PhD economists. There is therefore no doubt that DG Competition is able to apply the type of effects-based analysis it has itself recommended in its Guidance Paper.

A more nuanced view has to be taken with respect to the EU courts. The General Court, whose main task is to hear appeals lodged against competition decisions adopted by the Commission, is largely composed of generalist judges who join the Court with little or no background in competition law. A similar assessment can be made of the European Court of Justice, which comprises even fewer judges with expertise in competition law issues. Nothing would, of course, prevent the EU Courts from retaining economic experts to help them assess the strength of the economic arguments made by the Commission and the undertakings challenging Commission decisions, but the EU courts only did this in a limited number of circumstances in the past.[193] As will be discussed below, the EU courts have been unwilling, however, to look at economic arguments when reviewing Commission decisions.

While the EU Courts typically carry out a "full" review of the legal and the factual aspects of Commission decisions, they have traditionally applied a deferential standard of review to complex economic matters. In *Microsoft*, for instance, the General Court observed that it followed

> "*from consistent case-law that, although as a general rule the Community Courts undertake a comprehensive review of the question as to whether or not the conditions for the application of the competition rules are met, their review of complex economic appraisals made by the Commission is necessarily limited to checking whether the relevant rules on procedure and on stating reasons have been complied with, whether the facts have been accurately stated and whether there has been any manifest error of assessment or a misuse of powers*."[194]

The EU courts' case-law in the area of mergers, tends, however, to show that while perhaps subject to a less comprehensive or complete review than for issues of law and facts, the review of

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[192] Article 256 TFEU.

[193] Experts were, for instance, used in the Wood Pulp case, Case C-129/85 AhlströmOsakeyhtiö and Others v. Commission, [1993] ECR I-1307.

[194] Case T-201/04, *Microsoft v. Commission*, [2007] ECR II-3601, §87.

complex economic appraisals will nevertheless remain intense. As the Court of Justice noted in *Tetra Laval*, the fact that the Commission has a margin of discretion with regard to economic matters:

> "*does not mean that the Community Courts must refrain from reviewing the Commission's interpretation of information of an economic nature. Not only must the Community Courts, inter alia, establish whether the evidence relied on is factually accurate, reliable and consistent but also whether that evidence contains all the information which must be taken into account in order to assess a complex situation and whether it is capable of substantiating the conclusions drawn from it*."[195]

This clearly means that, while the EU courts are ready to recognize some leeway to the Commission, they will not authorize it to be careless in its assessments falling under the notion of complex economic appraisals.

The problem in the field of vertical restraints is not so much that the EU courts are unable to grasp economic reasoning, but that they stick to their formalistic case law, which is no longer in line with economic reasoning. For instance, although the *Hoffmann-La Roche* judgment of the ECJ was adopted in 1979, i.e. a period in which the influence of economics in EU competition law was minor, the position of the EU courts on fidelity rebates has not evolved at all. In fact, the legal tests developed by the Court of Justice in the field of abuse of dominance are sometimes so strict that they can almost accommodate any decision of the Commission even if it appears poorly in line with elementary economics. In other words, the problem is not one of judicial deference in the degree of control exercised by the General Court with respect of abuse of dominance decisions, but one of defective decision-making in that the legal standards relied upon by the Court are out of touch with contemporary economics (and even in some cases with basic common sense).

The problem is of course that this case-law has in turn a negative impact on the decisional practice of the Commission as can be illustrated by the*Intel* decision.[196] While in that decision the Commission carried out an "as efficient competitor" analysis to demonstrate that Intel's rebates were exclusionary, it claimed that this analysis was "not indispensable for finding an infringement under Article 82 of the Treaty [now Article 102 TFEU] according to the case-law."[197] Referring to *British Airways* and *Michelin II*, the Commission indeed notes that "for the purposes of establishing an infringement of Article 82 EC [now Article 102 TFEU], it is not necessary to demonstrate that the abuse in question had a concrete effect on the markets

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[195] *See* C-12/03 P, *Commission v. Tetra Laval* ("Tetra Laval II"), [2005] ECR I-987, §328.

[196] In *Intel*, the Commission considered that the Guidance Paper did not apply on the ground that this document "was published only after Intel had been given the opportunity to make its views known on the 26 July 2007 SO, the 17 July 2008 SSO and the Commission's letter of 19 December 2008." Intel decision, supra note 77, at § 916. The Commission however specified in its decision that it was "in line with the orientations set out in the guidance paper." Id.

[197] Id. at § 925.

concerned."[198] The Commission thus appears to be saying that no evidence of foreclosure is needed.

While this approach provides the Commission with the advantage that its decisions would become de facto "appeal proof",[199] it is detrimental to the objectives of the Guidance Paper. The reason is that this approach hardly gives any incentives to the Commission to carry out a serious effects-based analysis as in any event the case can be won on the basis of the strict case-law of the European Court of Justice. At best, the effects-based analysis is added to the decision to give the defendant the impression that the matter was thoroughly assessed by the Commission even if that thorough assessment was not necessary in the end.

This does not mean, however, that the Guidance Paper is useless. It is not, since it continues to provide a roadmap as to the way the Commission will pursue its enforcement of Article 102 TFEU. In other words, the Commission will use the methodology provided for in the Guidance Paper to decide whether to initiate proceedings against a dominant firm engaging in anti-competitive vertical restraints. Once the Commission has launched proceedings, it will continue to apply the methodology comprised in the Guidance Paper, but will also be able to rely on the case-law of EU courts to support its decision. A great step forward in the field of vertical restraints would be for the EU courts to modify the legal standards they apply to this field so as to better accommodate economic reasoning.

When it comes to the broader EU antitrust community, there is no doubt that its members (in-house and external counsel) are perfectly able to apply effects-based reasoning in the area of vertical restraints. In fact, EU competition lawyers were amongst the strongest supporters for an effects-based approach. In recent years, the number of competition economists has also grown tremendously in the EU and it is now the rule, rather than the exception, to have economists involved in competition cases. This is particularly the case since, as noted above, the Commission has itself strengthened its own economic analysis capabilities.

B. The Brazilian Institutional Background

In Brazil, as discussed above, the effects-based analysis has been incorporated in the legal system at least since 1994. Both BCA[200] and NBCA[201] define antitrust violations based on actual or potential effects, or on the conduct's scope to generate those effects. Besides the wording of the law itself, there is a general consensus emerging both from the case-law and the Brazilian legal scholarship about the adequacy of the effects-based approach to identify vertical restraints that violate competition laws. Thus, at the statutory level, it is fair to say that Brazil is ready to implement the analytical framework proposed.

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[198] Id. at § 922.

[199] The General Court and the ECJ would be most likely to uphold this decision as in line with their case-law.

[200] *See* BCA, articles 20 and 21.

[201] *See* NBCA, article 36.

However, the guidelines developed to evaluate anticompetitive conduct under BCA (i.e. CADE's Resolution 20)[202] are still insufficient to serve as the basis of a more detailed effects-based analysis. Indeed, the current guidelines merely suggest, at a very general level, that vertical restraints must be evaluated by balancing their potential negative effects with their efficiencies[203]. Moreover, some conducts discussed in this paper, such as loyalty rebates, are not even mentioned in the current guidelines.

In this context, new guidelines, incorporating the recent developments in economic and legal theory discussed in this paper, should be developed. The coming into force of NBCA is the right moment for developing such guidelines, as the authorities are already undergoing a complete overhaul of the regulations needed to implement the new law. Unlike the current guidelines, which attempt to address all conduct in a single regulation, the new guidelines could probably be developed in different Resolutions aimed at different types of conduct, applying the classic distinctions of horizontal and vertical restraints. This would allow for more detailed treatment of the conduct under analysis.

It would also be important to submit the new guidelines to public consultation in order to engage the whole competition policy community (i.e. lawyers, economists, sector regulators) in the debate. This would serve not only to seek comments and suggestions to improve the initial draft, but also to signal to the whole community that the authorities are willing to apply economic reasoning in the assessment of vertical restraints, improving its standards of proof and signalling more objective tests to assess such constraints.

With the normative framework in place, attention must be shifted to the Brazilian Competition Law System's capacity to implement the type of analysis recommended in Part V above which heavily relies on economic reasoning. On this matter, the authorities composing the Brazilian Competition Law System have received international recognition.[204] Indeed, they have been able to handle an increasing number of cases in recent years, with rising complexity, keeping a relatively constant staff.[205] Yet, staff constraints will certainly be a challenge to implement a demanding analytical framework such as the one proposed in this paper.

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[202] Resolution 20/1999

[203] *See* Resolution 20/1999, *Annex* I, Item B: "(…) *in order to be capable of harming competition, vertical restraints usually require [the undertaking] to hold market power in the "original" market, [with the conduct] producing effects on a significant part of a "target" market. Although in theory such restraints might hinder competition [in a given market], they might also present offsetting economic efficiencies that must be balanced against potential anticompetitive effects, according to a rule of reason approach*".

[204] For example, the Global Competition Review awarded CADE the prize of "Agency of the Year, Americas" in 2011.*See* http://www.globalcompetitionreview.com/news/article/29379/gcr-awards-2011-finalists/

[205] The latest data released from 2009, 2010 and 2011 shows that CADE held 24 judgment sessions in 2011, judging 814 cases: (i) 716 mergers; (ii) 16 administrative proceedings; (iii) 51 preliminary proceedings; (iv) 21 motions to clarify; and (v) 11 other proceedings (CADE's Annual Report to the OCDE, 2012, p. 10). This represents a 6,5% increase from 2010, when CADE held 24 judgments sessions, judging 765 cases: (i) 660 mergers; (ii) 20 administrative proceedings; (iii) 57 preliminary investigations; (iv) 13 motions to clarify and; (v) 15 other

(continued…)

The last Annual Report submitted by CADE to the OECD provided there were a total of 158 professionals dedicated to enforcing competition law and another 223 support staff in 2011 (see table below). Beyond the total numbers, it is important to draw attention to the following observations: (i) the SDE/DPDE, the main investigative authority, had only 39 professionals fully dedicated to enforcement of competition law, a number that would be considered very small even in much smaller economies; (ii) CADE, the administrative tribunal, had only 54 professionals dedicated to enforcement and a much larger number of support personnel; (iii) SEAE's personnel is not exclusively focused on competition policy, as they have taken up increasing responsibilities in the regulatory reforms taking place in different sectors (e.g. civil aviation, oil and gas, health and energy markets); and (iv) ProCADE, the legal service within CADE, responsible for handling all court cases, had only nine lawyers. It comes in no surprise that the last peer review published by the OECD in 2010 stated the obvious conclusion that the total number of people working in Brazilian Competition Law System *"is small for a country of Brazil's size"*[206].

Brazilian Competition Law System's Staff					
	SDE/DPDE	**SEAE**	**CADE**	**ProCade**	**MPF**
Professionals	**39**	**60**	**54**	**8**	**not avail.**
Support	**21**	**72**	**130**	**not available**	**not avail.**
Total	**70**	**132**	**184**	**-**	**-**

Source: CADE's annual report to the OECD (2012)

However, the lack of personnel is not the only difficulty faced by the Brazilian Competition Law System. The high staff turnover also undermines the Brazilian Competition Law System's capacity to handle complex vertical restraint cases. SEAE is a case in point. In the last OECD's peer review, SEAE reported losing 35% of its professional staff in one year (27 out of 77 professionals), hence making it difficult to build up expertise over time.[207] This high staff turnover affects SDE/DPDE and CADE as well. The fact is that Brazilian Competition Law System does not have a staff based on a body of civil servants selected specifically for competition policy enforcement. Most of the staff is composed of public policy experts, which can easily take up jobs in other parts of government[208].

proceedings. (CADE's Annual Report, 2010, p. 109) and a 51% increase from 2009, when CADE held 22 judgments sessions, judging 538 cases: (i) 474 merges; (ii) 18 administrative proceedings; (iii) 40 preliminary investigations; and (iv) 6 consultations (CADE's Annual Report, 2009, p. 57)

[206] *See* OCDE, Peer Review 2010, at 48.

[207] *Id.*

[208] According to OECD: *"Most of the professionals at SEAE* [as well as CADE and SDE] *are qualified either as experts in public policy and governmental management or financial analysts. As such, they are more ready to consider positions at other government agencies when they become available". Id.*

Besides the high turnover, the staff is largely composed of lawyers; hence the need to engage in deeper economic analysis would certainly require a more balanced staff, including a greater proportion of officials with an economics background. With the exception of SEAE, which has been able to attract a number of economists, the Brazilian Competition Law System has been mainly focused on attracting lawyers to its staff positions. SDE/DPDE is a good example as in 2012, out of the 39 professionals dedicated to competition policy enforcement, 20 were lawyers, 8 were economists and 11 had other academic backgrounds[209]. In other words, there is one economist for every 2.5 lawyers in SDE/DPDE. Similarly, CADE's personnel was composed of 34 lawyers, 14 economists and 6 other professionals, or a similar ratio.

The NBCA, which will come into force by mid-2012, presents a good opportunity to boost the staff capacity of the New CADE, but it also brings some pitfalls. Indeed, the NBCA provides express congressional authorization for contracting 200 new permanent staff, especially selected for competition policy enforcement. This is a significant opportunity to select a balanced staff of lawyers and economists to bring Brazilian competition policy to the same level as mature jurisdictions worldwide. In addition, the new law creates an Economic Department within CADE, demonstrating a commitment to economic reasoning in competition policy enforcement.[210]

On the other hand, under the NBCA, because SEAE will no longer be dedicated to enforcement of competition policy, and most of its staff is not expected to be transferred to the New CADE, SEAE's expertise will not be transferred to the new authority. Therefore, there is a risk that the New CADE will initially suffer from losing part of the expertise of SEAE. Yet, it will have the tools to rebuild and expand this expertise when the 200 new staff becomes operational. The staff expansion approved by the NBCA is probably the single most important institutional enhancement in Brazilian competition policy in the past 20 years and should be treated with great priority, as it will certainly give the New CADE the capacity to implement a more analytically complex framework of the type proposed in this paper.

Besides the authorities, Courts will always play an important role in complex cases as any large fine imposed on a dominant undertaking is likely to be reviewed by Brazilian Federal Courts since the defendant has the alternative to challenge CADE's final decision. The question is whether Courts are prepared to review decisions regarding vertical restraints, which are based on economic reasoning.

The answer to this question is far from clear in Brazil. On the one hand, Brazilian courts are still very formalistic with judges mastering procedural rules, but having little specific training in competition law and, usually, no background at all in economics. This makes any review of a complex vertical restraint case a significant challenge. On the other hand, judges may develop a standard of review based on a certain degree of deference to the economic analysis of the authorities, and focused more on procedural guarantees.

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[209] CADE's Annual Report to the OECD, 2012, at 23.

[210] NBCA, article 5, item III and article 121.

Should the courts opt for a full fledge judicial review of the merits of a case, there is no doubt that a complex vertical restraint case will turn into a battle of experts. A generalist judge would likely face significant difficulties in reviewing the types of tests proposed for loyalty rebates in this report. This being said, generalist judges will experience the same difficulties when reviewing decisions dealing with predatory pricing, complex mergers and any other case requiring economic analysis (including in other areas of law such as utilities regulation).

Therefore, although courts are unlikely to be prepared for a review of the merits of a decision dealing with a complex vertical restraint, this should not be an excuse for Brazilian Competition Law System not to implement a more sophisticated analysis of these cases. The competition authority and the private parties will have to learn to deal with the limits of the courts, as they have learned to do in other matters. As to the courts, they will have to adapt the standard of judicial review to the aspects they are most suitable to evaluate. Here, the challenge in Brazil seems similar to that in the EU, in finding a balance between some degree of deference and the court intervention to require a rigorous analysis from the administrative authorities.

Last but not least, in order to implement more detailed standards of analysis for vertical restraints, the antitrust community as a whole must be prepared to deal with this type of analysis. This means that both in-house and outside counsel must familiarize themselves with complex legal and economic arguments and develop the means to search and process the type of empirical data that is needed to advise and litigate vertical restraint cases.

It is fair to say that the Brazilian antitrust community is quite sophisticated and could certainly take up this challenge. In the past decade, attorneys and economists have been exposed to an increasingly complex array of arguments and economic tools.[211] For instance, in complex cases, parties, attorneys and economic consultants are familiar with econometric tests to define relevant markets[212] as well as post-merger price simulations.[213] In some recent cases, the tools relied upon were more complex than those suggested in this paper. Should the authorities adopt clear guidelines based on sound economic reasoning, the antitrust community as a whole would be prepared to apply them to concrete cases.

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[211] For an interesting overview of the cases with more complex economic analysis in Brazil see Cesar Mattos, A Revolução do Antitruste no Brasil: O Papel da Teoria Econômica Aplicada a Casos Concretos, São Paulo, Editora Singular, 2003..The book (published in Portuguese) is clearly inspired by and adopts a similar format to the book Antitrust Revolution edited by John E. Kwoka Jr. and Lawrence White in the USA, presenting studies in cases where deep economic analysis was required. JOHN E. KWOKA Jr. and LAWRENCE WHITE, THE ANTITRUST REVOLUTION: ECONOMICS, COMPETITION, AND POLICY, Oxford University Press, 2004.

[212] *See, e.g.,* the Ambev Case (Concentration Act 08012.005846/1999-12), using elasticity tests to define relevant markets and evaluate market power in the beer industry, as well as the Braskem-Ipiranga (Concentration Act 08012.002818/2007-14) and Brakem-Quattor (Concentration Act 08012.001205/2010-65) Cases, using detailed econometric tests (e.g. co-integration, granger causality) for defining geographic relevant markets in the petrochemical industry.

[213] *See* Nestle-Garoto Case (Concentration Act 08012.001697/2002-89) and, more recently, Sadia-Perdigão Case (Concentration Act 08012.004423/2009-18), using post-merger price simulations in chocolate markets and processed food, respectively.

In this context, the Brazilian antitrust environment seems reasonably well prepared to implement the analytical framework suggested in this paper, with, however, some important areas for improvement. These areas include: (i) developing more detailed regulations with guidelines to assess vertical restraints under the NBCA, (ii) using the opportunity opened by the NBCA for an expansion of staff that is balanced between lawyers and economists; and (iii) improving the ability of the courts to deal with economic arguments and/or developing standards of judicial review including some deference to the substantive economic analysis.

VIII. Conclusions

Exclusive dealing, rebates and tying are common commercial practices adopted by both dominant and non-dominant firms. In the vast majority of instances, these practices are pro-competitive and a source of considerable efficiencies. There may be instances, however, where such practices may produce foreclosure effects. The task of competition authorities and courts in any jurisdiction is therefore to separate pro-competitive from anti-competitive restraints, and only prohibit the latter.

Because vertical restraints can be a source of efficiencies, *per se* rules of illegality should be avoided as they can lead to the over-enforcement of competition rules and thus prohibit some pro-competitive types of conduct. Rules that try to distinguish between pro- and anti-competitive conduct based on the form of such conduct (e.g., whether a rebate is labelled as a "fidelity" rebate (which would be illegal) or a "volume" rebate (which would be sometimes acceptable)) should also be avoided as the form of a measure says little about its impact on competition. The application of form-based rules may therefore lead to significant errors of assessment and affect the credibility of the competition regimes in question, as some examples in mature jurisdictions as the EU and the US have illustrated.

Instead, competition authorities and courts should adopt tests seeking to identify the pro- and anti-competitive effects of a given conduct and balancing them. No vertical restraint should be banned without the demonstration that it affects competition and creates consumer harm. Such effects-based analysis must be developed according to a solid analytic framework, in order to establish consistent standards of proof. Indeed, in the absence of such framework, even with an alleged effects-based approach, authorities may end up developing inconsistent standards of proof with decisions outcomes that may come close to a form-based analysis, as the Brazilian experience illustrates.

In this context, the Guidance Paper adopted by the Commission in December 2008 attempts to structure, in a fairly detailed manner, such an effects-based approach. Although the Guidance Paper contains some shortcomings, as we observed in the context of conditional rebates, it offers a useful conceptual framework for the analysis of vertical restraints adopted by dominant firms.
This effects-based approach contained in the Guidance Paper, which relies on modern economic thinking, is largely followed by US agencies and courts, as well as by enforcement agencies and

courts in many other nations.[214] It is also supported by the vast majority of competition law and economics scholars around the world.

For rapid developing jurisdictions like Brazil, which are attempting to leapfrog some of the earlier stages of more mature jurisdictions, the analytical framework proposed by the Guidance Paper could serve as a starting point to provide some hard edge to an otherwise soft effects-based approach applied by the authorities so far. Indeed, in Brazil, the problem is not so much that there is a lack of consensus over an effects-based approach, but the fact that this approach is carried out through balancing tests relying on qualitative, rather than quantitative, criteria. This leads to considerable inconsistency and uncertainty. With some adaptations to the reality of these developing jurisdictions, new guidelines could be used to establish substantive standards to evaluate vertical restraints, leading to a healthy convergence of analytical approaches based on modern economic theory.

Finally, this article also calls attention to the importance of the institutional environment to implement the proposed analytical framework. We discussed five different institutional elements: legislation, regulations with guidelines to implement the legislation, authorities' capability to develop sound economic analysis, courts' readiness to review this type of analysis and the antitrust community (i.e. in-house and outside counsel and economic consultants). The interplay among these elements is very important for the success of more robust analysis of vertical restraints. Although, both the EU and Brazil seem to be fairly prepared to implement the type of analysis proposed in this article, there is certainly room for improvement, especially in Brazil.

[214] See Elhauge and Geradin, supra note 3, at Chapter III.