

Assessment of conduct

Draft competition law guideline for consultation

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Articles 81 and 82 of the EC Treaty and the Competition Act 1998 are applied and enforced in the United Kingdom by the Office of Fair Trading (the OFT). In relation to the regulated sectors these provisions are applied and enforced, concurrently with the OFT, by the regulators for communications matters, gas, electricity, water and sewerage, railway and air traffic services (under section 54 and schedule 10 of the Competition Act 1998) (the Regulators). Throughout the guidelines, references to the OFT should be taken to include the Regulators in relation to their respective industries, unless otherwise specified.

The following are Regulators:

- the Office of Communications (OFCOM)
- the Gas and Electricity Markets Authority (OFGEM)
- the Northern Ireland Authority for Energy Regulation (OFREG NI)
- the Director General of Water Services (OFWAT)
- the Rail Regulator¹ (ORR), and
- the Civil Aviation Authority (CAA).

This guideline provides general advice and information about the application and enforcement by the OFT of Articles 81 and 82 of the EC Treaty and the Chapter I and Chapter II prohibitions contained in the Competition Act 1998. It is intended to explain these provisions to those who are likely to be affected by them and to indicate how the OFT expects them to operate. Further information on how the OFT has applied and enforced competition law in particular cases may be found in the OFT's decisions, as available on its website from time to time.

This guideline is not a substitute for the EC Treaty nor for regulations made and notices provided under it. Neither is this guideline a substitute for the Competition Act 1998 and the regulations and orders made under it. It should be read in conjunction with these legal instruments, Community case law and United Kingdom case law. Anyone in doubt about how they may be affected by the EC Treaty and the Competition Act 1998 should seek legal advice.

¹ This will change to the Office of Rail Regulation on 5 July 2004.

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1 INTRODUCTION

- 1.1 The EC Treaty² and the Competition Act 1998 (the Act) both prohibit agreements³ which prevent, restrict or distort competition and conduct which constitutes abuse of a dominant position. EC Regulation 1/2003 (the Modernisation Regulation)⁴ allows national competition authorities of the Member States (NCAs) and the courts of the Member States to apply and enforce Articles 81 and 82 of the EC Treaty (Article 81 and Article 82 respectively). A more detailed explanation of the Modernisation Regulation is set out in the competition law guideline *Modernisation* (OFT442).
- 1.2 The competition law guideline *Article 82 and the Chapter II prohibition* (OFT402) describes the concepts of dominance and abuse. This guideline provides guidance on how certain conduct by **dominant undertakings**⁵ (whether individually or collectively dominant) that might be prohibited under Article 82 and/or the Chapter II prohibition of the Act will be assessed by the OFT. An abuse may be exploitative (e.g. excessive pricing) or exclusionary (e.g. predation). However, no guidelines can be exhaustive, and conduct which is not covered by, or referred to in, this guideline should not be assumed to be beyond the scope of the prohibitions.
- 1.3 Parts 2 to 6 of this guideline cover pricing practices, respectively: excessive prices, price discrimination, predation, discounts, and margin squeeze. Part 7 discusses vertical restraints and Part 8 refusal to supply and essential facilities.

² The Treaty of Rome, establishing the European Community, as consolidated by the Treaty of Amsterdam.

³ References in this guideline to 'agreements' should, unless otherwise stated or the context demands it, be taken to include decisions by associations of undertakings (see footnote 5 below) and concerted practices.

⁴ 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 (OJ L1, 4.1.03, p. 1).

⁵ The term undertaking is not defined in the EC Treaty or the Act, but its meaning has been set out in Community law. It covers any natural or legal person engaged in economic activity, regardless of its legal status and the way in which it is financed. It includes companies, partnerships, firms, businesses, individuals operating as sole traders, agricultural cooperatives, associations of undertakings (e.g. trade associations), non profit making organisations and (in some circumstances) public entities that offer goods or services on a given market.

1.4 This guideline refers to some technical concepts. These terms are explained in footnotes to the text and in the glossary at the end of this guideline.

2 EXCESSIVE PRICES

Introduction

2.1 The charging of excessive selling prices by a dominant undertaking may be an infringement of Article 82 and/or the Chapter II prohibition.⁶ The European Court has held that:

'charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied... would be... an abuse'.⁷

2.2 In *United Brands* the European Court went on to declare that a detailed analysis of costs would be required before any judgement of excessive prices could be reached and added that the question to be asked was:

'... whether the difference between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to other competing products.'⁸

2.3 Not only might excessively high prices be exploitative but they may also harm competition.⁹ For example, an undertaking dominant in the supply of an important input might well be in a position to set excessive prices which make it more difficult for undertakings that require the input to enter or to compete in related markets.¹⁰

2.4 Excessive prices may also be a sign that the process of competition is not working effectively. This would be the case, in particular, where a dominant undertaking combines excessive prices with exclusionary

⁶ Article 82 and the Chapter II prohibition prohibit dominant undertakings from directly or indirectly imposing unfair purchase or selling prices.

⁷ Case 27/76 *United Brands v Commission* [1978] ECR 207, [1978] 1 CMLR 429 at paragraph 250 (**United Brands**). See also the decision of the European Commission in *Deutsche Post AG – Interception of cross-border mail* OJ [2001] L331/40, where the European Commission found the price charged by a monopolist excessive where it had 'no sufficient or reasonable relationship to real costs or to the real value of the service provided'.

⁸ *United Brands* at paragraph 252

⁹ This part discusses the analysis of selling prices. However, it is conceivable that the extraction of unfair or excessively low buying prices by a dominant buyer could also be an abuse.

¹⁰ In the extreme, the price may be so high that it amounts to 'constructive' refusal to supply. Refusal to supply is discussed in Part 8.

behaviour designed to protect its ability to maintain those excessive prices. In this case, both practices could be found abusive.

- 2.5 It is important, however, to distinguish excessive prices from seemingly high prices that are an integral part of the competitive process. For example, high prices may reflect short term shifts in demand or supply, provide a fair return on earlier investments, or act as a signal for existing and potential competitors, respectively, to expand output and to enter a market.

Evidence on excessive prices

- 2.6 In assessing questions about excessive pricing, the OFT would usually look for evidence that prices are substantially higher than would be expected in a competitive market, and that there is no effective competitive pressure to bring them down to competitive levels, nor is there likely to be.

Cost and price benchmarks

- 2.7 In order to address whether an undertaking's prices are higher than would be expected in a competitive market, the following benchmarks might be considered:
- **comparisons with prices of the same products¹¹ in other markets.** These might be useful where identical comparator products are sold in more competitive markets (e.g. markets characterised by lower concentration, lower entry barriers and no collusive behaviour), provided that these markets are subject to similar cost conditions as the market in question
 - **comparisons with underlying costs.** Where it is possible to derive an economically meaningful measure of an undertaking's own costs, then evidence that prices were persistently and significantly in excess of these costs could be evidence of excessive pricing (see excessive profits below), and

¹¹ The term product is used for convenience and should be interpreted throughout this guideline to mean good, service or property right.

- **comparison with prices in another time period.** Evidence that prices were substantially higher than those of a period when competition was more effective might provide evidence of excessive pricing, provided that there were no other good explanations for the price rise (e.g. a substantial increase in cost).

2.8 The above list of indicators is not exhaustive and the analysis of excessive prices will depend on the case in hand. To demonstrate that excessive prices had been set, several indicators would usually be considered¹² as well as the possibility that seemingly high prices are an integral part of the process of competition in the market concerned (see paragraph 2.16 *et seq*).

Excessive profits

2.9 In a competitive market, an undertaking would be expected to earn 'normal profits' on any particular activity. These refer to the level of profits that an undertaking requires to provide a sufficient return to the lenders and shareholders that provide the undertaking with finance. This rate of return is referred to as the undertaking's 'cost of capital'. When the undertaking's profitability persistently exceeds its cost of capital profits are said to be 'supra-normal'.

2.10 Evidence of supra-normal profits may indicate that competitive pressure was not strong enough to keep prices at competitive levels and bolster other evidence that excessive prices were being charged.¹³ However, supra-normal profits will not always indicate competition problems (see paragraph 2.16 *et seq*).

2.11 When considering whether supra-normal profits have been earned, a variety of measures may be considered:

¹² In *Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading* [2002] CAT 1 (**Napp**) the Competition Appeal Tribunal (CAT) considered that comparisons of (i) Napp's prices with Napp's costs, (ii) Napp's prices with the costs of its next most profitable competitor, (iii) Napp's prices with those of its competitors and (iv) Napp's prices with prices charged by Napp in other markets were among the approaches that could reasonably be used to establish excessive prices in that case (paragraph 392). The CAT also noted that there are other methods that may reasonably be used to establish excessive prices.

¹³ Although excessive prices would normally result in high profits, this will not always be the case: an undertaking protected from competition might be under less pressure to control its costs. Information on appropriate cost comparators might help to indicate whether costs have been incurred efficiently.

- Economic measures of profitability include the internal rate of return (IRR) and net present value (NPV). When an undertaking's IRR exceeds its cost of capital or when its NPV is greater than zero, this implies that its profitability exceeds its cost of capital.
- Given that the period over which prices are alleged to be excessive may be less than the economic lifetime of an activity, it may be more appropriate to employ measures such as return on sales, gross margins, 'truncated IRR',¹⁴ return on capital employed,¹⁵ and market valuations.
- Evidence on how an undertaking's profitability compares with that of similar undertakings operating in a competitive market may also be considered.

2.12 Undertakings often supply several markets. Often it is not the overall profitability of an undertaking which is at issue but rather the profits the undertaking earns from an individual line of business in a particular market where it enjoys a dominant position. Where a dominant undertaking does not generate supra-normal profits overall, this does not rule out the possibility that it charges excessive prices on a particular line of business.

2.13 Where an undertaking produces several products, certain costs may be 'common' to more than one product. To assess the profitability of a line of business it may be necessary to allocate common costs to the particular activities identified. Whether and how this should be carried out will depend on the circumstances of the case.¹⁶

2.14 A profitability assessment can require an element of judgement about the relevant rates of return, the valuation of assets, the appropriate cost of

¹⁴ The truncated IRR facilitates assessment of profitability over a defined period by imputing appropriate asset valuations at the beginning and end of the relevant period. It requires reliable information on, for example, cashflow and asset valuations.

¹⁵ An undertaking's return on capital employed will, when certain conditions apply, give similar results to a truncated IRR, and it too can also be compared to the cost of capital.

¹⁶ In some circumstances the stand alone cost of the line of business may also be relevant. The stand alone costs of a line of business include those costs that would be incurred if the company undertook only the line of business in question. Where an activity generates revenues that persistently and significantly exceed its stand alone cost (including the cost of capital), this would be good evidence of excessive profits being earned on that activity.

capital, and the appropriate cost and revenue allocation methods. No presumption should be made about what measure of profitability will be used, as the appropriateness of different measures will vary with each case and all the relevant evidence will be considered as a whole.

- 2.15 It is unlikely that a dominant undertaking would be found to have charged excessive prices solely on the evidence of supra-normal profitability. The analysis would usually consider other indicators, such as the cost and price comparators described above, as well as whether supra-normal profits could be justified as a fair return on an earlier investment.

When apparently high prices or profits are not excessive

- 2.16 Prices and profits of a dominant undertaking which, at first sight, might appear to be excessive will not always amount to an abuse. First, high prices will often occur for short periods within competitive markets. For example, an increase in demand that could not be met by current capacity or a supply shock that reduced production capacity would lead to higher prices. Where high prices are temporary and/or likely to encourage substantial new investment or new entry, they are unlikely to cause concern.
- 2.17 Second, an undertaking might be able to sustain supra-normal profits for a period if it was more efficient than its competitors. In this case, the efficient undertaking might simply be reaping the rewards of having developed lower-cost techniques of production, supplied higher quality products or been more effective at identifying market opportunities. This might be shown by the fact that the other (less efficient) undertakings in the market were not earning high profits relative to their cost of capital.
- 2.18 Third, prices and profits may be high in markets where there is innovation. Successful innovation may allow a firm to earn profits significantly higher than those of its competitors. However, a high return in one period could provide a fair return on the investment in an earlier period required to bring about the innovation. These costs include investment in research and development and should take into account

the risk at the time of the investment that the innovation might have failed.¹⁷

- 2.19 In markets where undertakings innovate regularly, high profits may be temporary, for example because they act as a spur to competitors to innovate further and to the incumbent to innovate to maintain its position. Persistently high prices and profits are unlikely to be of concern if they result from a series of successful innovations, as distinct from exclusionary or collusive behaviour.
- 2.20 It is important not to interfere in natural market mechanisms where high prices and profits will lead to timely new entry or innovation and thereby increase competition. In particular, competition law should not undermine appropriate incentives for undertakings to innovate. Concern about excessive prices will be more likely in markets where price levels are persistently high without stimulating new entry or innovation.

¹⁷ This risk might be reflected in the cost of capital.

3 PRICE DISCRIMINATION

Introduction

3.1 An undertaking can be said to be discriminating when it applies dissimilar conditions to equivalent transactions with other trading parties. The most direct way is through the prices charged to different sets of customers. It can take two basic forms:

- an undertaking might charge different prices to different customers, or categories of customers, for the same product - where the differences in prices do not reflect any differences in relative cost, quantity, quality or any other characteristics of the products supplied
- an undertaking might charge different customers, or categories of customers, the same price even though the costs of supplying the product are in fact very different. A policy of uniform delivered prices throughout the country, for example, could be discriminatory if differences in transport costs were significant.

3.2 For price discrimination to be feasible an undertaking not only has to be able to segment the market in some way, but must also be able to enforce the segmentation, so that trading between the different categories of customer who are charged different prices is not possible.

3.3 Price discrimination occurs frequently and in a wide range of industries, including industries where competition is effective. It is a generic term that covers many specific types of pricing behaviour that can be either good for consumers or anti-competitive. Therefore, it is not necessarily the case that price discrimination by a dominant undertaking is an abuse.

Price discrimination as an abuse

3.4 Price discrimination, and discrimination more generally, by a dominant undertaking may be an abuse under Article 82 and/or the Chapter II prohibition. Price discrimination raises two potential issues. First, it may be exclusionary. For example, a dominant undertaking may use a discriminatory pricing structure to set predatory prices (see Part 4) and/or to set discounts which have the effect (or likely effect) of foreclosing all, or a substantial part, of a market (see Part 5). Where a vertically

integrated undertaking is dominant in an upstream market and a competitor in a related downstream market, it may use discriminatory pricing to apply a margin squeeze that distorts competition in the downstream market (see Part 6).

- 3.5 Second, price discrimination may allow an undertaking to exploit market power by charging excessively high prices to certain customers (see Part 2).
- 3.6 When considering whether price discrimination is an abuse, it is often relevant to consider whether the pricing structure in question allows the efficient recovery of fixed costs and expands demand substantially or opens up new market segments.
- 3.7 For example, undertakings often have fixed costs of production (costs which do not vary directly with output, at least in the short run). This means that they will usually need to set at least some prices above their average variable costs to generate sufficient revenues to break even (i.e. earn normal profit). In this case, price discrimination can be beneficial if it leads to a sufficiently large increase in output in relation to the output level that would have pertained if there was no price discrimination. Indeed, in some cases price discrimination may allow a new market segment to emerge. This might occur, for example, in industries characterised by relatively high fixed costs, where customers can be split up into groups according to their willingness to pay, and where groups with low willingness to pay would not buy in the absence of price discrimination.¹⁸
- 3.8 Just because price discrimination can be beneficial does not mean that the chosen form of price discrimination adopted by a dominant undertaking in that industry is presumed beneficial. Price discrimination will be assessed on a case-by-case basis.

¹⁸ For example, consider a hypothetical dominant train operator that sets different prices for peak and off-peak rail travel. Charging commuters (who have a higher willingness to pay than leisure travellers) a higher price so as to recover a bigger proportion of fixed costs may allow a train operating company to reduce the share of these costs recovered from off-peak travellers. This may increase output overall since if both categories of customers were charged the same price, off-peak travellers might switch to another mode of transport or not travel at all, leaving peak travellers to bear more of the fixed costs. In the extreme, this might lead to both peak and off-peak travellers switching to other modes of travel or not travelling at all.

Non-price issues

- 3.9 Discrimination should be regarded as applying dissimilar conditions to equivalent transactions or similar conditions to different transactions; it is not concerned solely with price. Discrimination on terms other than price can also have anti-competitive effects. For example, an undertaking which controlled the supply of a key input might supply a downstream undertaking with a poorer quality of service than it provides to its own business competing in the same downstream market (delivery taking longer, for example). If the difference in service quality were not reflected in the pricing by the upstream undertaking, the undertaking could be regarded as acting in a discriminatory way.
- 3.10 The analysis of non-price discrimination, e.g. quality of service discrimination, would be similar to that for price discrimination. This is because raising the price for a product of a given quality is effectively the same as lowering the quality of a product sold at a given price. As with price discrimination, the non-price discrimination will not necessarily be abusive. It would be abusive only where it was exploitative or reduced (or could be expected to reduce) existing or potential competition.

4 PREDATION

Introduction

- 4.1 Predation is strategic behaviour whereby an undertaking deliberately incurs losses in order to eliminate a competitor so as to be able to charge excessive prices in the future. It occurs where prices are so low¹⁹ that they could force one or more undertakings out of the market, threatening the competitive process itself.²⁰ Predation practised by an undertaking holding a dominant position will be an abuse.
- 4.2 Although consumers may benefit in the short term from such lower prices, in the longer term consumers will be worse off due to weakened competition which leads to higher prices, reduced quality and less choice. A number of issues may be relevant to an assessment of whether predation is taking (or has taken) place. This part addresses the following issues:
- pricing below cost
 - intention to eliminate a competitor, and
 - the feasibility of recouping losses.

Pricing below cost

- 4.3 Usually, when assessing predation, the first question is whether the dominant undertaking is pricing below cost. This involves an assessment of:
- the relevant time period over which to measure revenues and costs
 - the relevant revenues generated over that time period, and hence the relevant price, and
 - the relevant cost benchmark to use during that time period.

¹⁹ This part focuses on predatory prices. However, the analysis could apply equally to predatory behaviour that involves increases in output.

²⁰ A predatory strategy may harm competition without necessarily eliminating a competitor.

Relevant time period

- 4.4 The relevant period over which to measure revenues and costs depends on the case in hand. The relevant time period is usually that over which the alleged predatory price(s) prevailed or could reasonably be expected to prevail. However, this does not rule out the use of other time periods in appropriate circumstances. For example, suppose that the period of alleged predation covered two years and that in some months prices were much lower than others. In this case, it may be relevant to consider not only whether predation occurred during the whole period of alleged predation but also whether it occurred during the shorter periods of particularly aggressive pricing.

Relevant price

- 4.5 The relevant price depends on the case in hand. In some cases, the price may be stable and easy to observe. In other cases, for example where the price varies over the relevant time period or between customers, it may be appropriate to consider the relevant price to be average revenues from the particular sales that are alleged to have been made at a predatory price.

Cost benchmarks

- 4.6 This section considers three cost benchmarks: variable costs, avoidable costs, and incremental costs.

Variable costs

- 4.7 Variable costs are those costs that vary directly with output. The variability of a cost, and hence the level of variable costs, will depend on the time frame under consideration. The longer the time frame under consideration, the greater the opportunities for undertakings to respond to changes in output by changing their production processes and capacity. Given sufficient time, all costs are variable to a certain degree.

Avoidable costs

- 4.8 Avoidable costs are those costs which could be avoided if the undertaking were to cease the activity in question over the relevant time

period. The 'activity' referred to here is the production of the product (or group of products) that is the subject of the investigation. Variable costs are avoidable since these costs will not be incurred if the activity in question is ceased. Where a cost is deliberately sunk as part of a predatory activity such a cost is also avoidable (even though, once sunk, the cost does not vary with output).²¹

- 4.9 When measured over the same period, variable costs and avoidable costs may often be similar. In *Aberdeen Journals (No. 2)* the CAT noted that measuring avoidable costs over the period of the alleged predation, or an intermediate period of one year, would, in practice, have given very similar results to measuring what costs were variable over the same period.²² In cases where avoidable costs and variable costs are not very similar, it may be useful to consider whether an undertaking is covering its avoidable costs. Evidence that an undertaking prices below its average avoidable costs (AAC) may be relevant evidence when assessing an undertaking's intention (see below).

Incremental costs

- 4.10 Incremental cost refers to the additional cost of increasing output beyond a benchmark level of output by some pre-specified amount (the 'increment'). Incremental costs differ according to the time period over which they are measured. In certain sectors (for example telecommunications), long run incremental cost (LRIC)²³ may be a preferable cost benchmark to variable cost.²⁴

²¹ For example, if a dominant undertaking made a sunk investment in new capacity for the purpose of its predatory campaign, this investment would be treated as an avoidable cost.

²² See *Aberdeen Journals Limited v The Office of Fair Trading* [2003] CAT 11 (**Aberdeen Journals (No. 2)**) at paragraph 385.

²³ LRIC takes into account the total long run cost, both of capital and operating, of supplying a specified additional unit of output such as a new service.

²⁴ See the European Commission's *Notice on the Application of Competition Rules to Access Agreements*, OJ [1998] C 265/2, [1998] 5 CMLR 821 and the competition law guideline *The application of competition law in the telecommunications sector* (OFT417). See also the European Commission's decision in *Deutsche Post AG* OJ [2001] L125/27.

Pricing below average variable cost

4.11 In *AKZO*,²⁵ the European Court held that where prices are below the average variable cost (AVC) of production, predation should be presumed. However, as noted in *Aberdeen Journals (No. 2)*, this presumption can be rebutted.²⁶

4.12 Some possible legitimate commercial reasons for pricing below AVC are set out below:

- **loss leading:** loss leading occurs where a retailer cuts the price of a single product in order to increase sales of other products. Loss leading would not normally be considered predatory unless it was clear that the intention was to eliminate a competitor
- **short run promotions:** these often involve selling below AVC for a limited period and are widely used in many markets, especially where a new product is introduced to a market. A dominant undertaking which adopts a one-off short term promotion of this type is unlikely to be found to have engaged in predation. However, a series of short term promotions could, taken together, amount to a predatory strategy. The time period which may be regarded as short term will inevitably vary from case to case, and it is not possible to provide general guidance as to what may and may not be abusive
- **network effects:** there are some services where the addition of more customers to the network adds to the value of the service sold to existing customers.²⁷ In these circumstances, it can be beneficial for the undertaking to sell part of the service to customers at below AVC. This will encourage expansion of the network, which benefits all network customers who then have access to a larger number of subscribers. The undertaking may then recoup the loss by charging higher prices for other, related services
- **economies of scale and new products:** in some cases an undertaking may introduce a new product to the market at a loss-making price in order to build up a large enough customer base to allow it to achieve

²⁵ Case C62/86 *AKZO Chemie BV v Commission* [1991] ECR I-3359 (**AKZO**).

²⁶ *Aberdeen Journals (No. 2)*, paragraph 357.

²⁷ Network effects may also be relevant for goods as well as services.

and benefit from economies of scale, at which point the price would become profitable

- **unanticipated shocks:** in some markets demand and/or costs can be volatile and difficult to anticipate. For example, in some cases an undertaking may temporarily fail to cover its AVC because of unanticipated increases in input costs, or unanticipated reductions in demand, and
- **option value:** in some cases, for example in response to an unexpected fall in demand, an undertaking may wish to maintain a presence in the market (although it incurs short run losses in doing so) in case demand returns to profitable levels. This would be more likely to occur in a market which, once exited, would involve substantial sunk costs to re-enter.

4.13 Where a dominant undertaking prices below AVC in the market in which it holds dominance, defences which rely on the need to obtain an efficient scale of production may not be persuasive since the undertaking would already be large in relation to the market. However, such defences may still apply where an undertaking dominant in one market is alleged to have preyed in a related market, in which it is not dominant.

Predation and pricing between AVC and average total cost

4.14 Predatory conduct is possible where an undertaking prices above its AVC and below its average total cost (ATC).²⁸ In *AKZO*, the European Court held that if prices are above AVC but below ATC, conduct is to be regarded as predatory where it can be established that the purpose of the conduct was to eliminate a competitor.²⁹ The question of intention is considered below.

²⁸ Total costs are the sum of variable costs and fixed costs, fixed costs being those costs that do not vary with output over the relevant period.

²⁹ See also Case C-333/94P *Tetra Pak v Commission* [1996] ECR I-5951 (**Tetra Pak II**).

Intention to eliminate a competitor

4.15 This section describes the factors often considered when assessing whether an undertaking's intention is to eliminate a competitor.

Direct evidence of intentions

4.16 Documentary evidence may be used to determine whether an undertaking intended to predate. For example, in *Aberdeen Journals (No. 2)*, the CAT found that internal documents clearly demonstrated that the dominant undertaking used low prices in an attempt to force a competitor out of the market.³⁰ Evidence from a credible witness may also prove that an undertaking intended to eliminate a competitor.

4.17 If a dominant undertaking adopts a predatory pricing policy with the intention of eliminating a competitor (e.g. as evidenced by its own internal documents), it will be presumed to have that intention for as long as the pricing policy continues.³¹

Conduct makes no commercial sense apart from harm to competition

4.18 It may be relevant to consider whether the undertaking's strategy makes commercial sense only because it eliminates a competitor.³² For example, there might be other strategies open to the dominant undertaking that would have met its other commercial objectives just as well while being less likely to harm competition.

4.19 As noted above, pricing below AVC leads to the presumption of an abuse. Even where prices are above AVC, when a dominant undertaking intentionally prices below AAC, it deliberately incurs a loss, since it would make a greater profit from not producing at all. Therefore pricing below AAC may be evidence of an intention to eliminate a competitor in the absence of legitimate commercial reasons for that pricing strategy.

³⁰ See paragraphs 425 to 432.

³¹ *Aberdeen Journals (No. 2)* at paragraph 431.

³² A dominant undertaking might present revenue forecasts which demonstrate that, while it expects to incur losses in the short term, its pricing strategy would be profitable in the long term. In this case, when assessing whether the undertaking's strategy makes commercial sense apart from exclusion, it would be necessary to strip out any of the revenues that are expected as a result of the elimination of a competitor.

4.20 A dominant undertaking would not be able to justify deliberately incurring losses on one product by higher profits earned on another product where the latter profits resulted from eliminating a competitor. For example, in *Napp*, the fact that losses made from below cost prices in the hospital segment of the market were outweighed by profits earned on excessive prices in the community segment was not a legitimate reason for the low prices in the hospital segment. This was because the low prices in the hospital segment were part of an exclusionary strategy designed to protect *Napp*'s ability to charge high prices in the community segment.

Other behavioural evidence of intention

4.21 Other forms of behaviour by the dominant undertaking may also indicate an intention to engage in predation against a rival. For example, the targeting of price cuts against a competitor, while higher prices were maintained elsewhere, might indicate predatory intent.³³

4.22 Further evidence might include the frequency of the behaviour. For example, if the behaviour is part of a pattern of aggressive pricing or other conduct that impedes competition, it is more likely to provide evidence of predatory intent than if it had been isolated.

4.23 It may also be relevant to consider whether the alleged predatory behaviour would be likely to eliminate a competitor. A number of factors would be relevant in this context. First, whether the scale of the pricing strategy is sufficient to raise a reasonable possibility that it would eliminate a competitor. Second, whether the financial resources of the alleged predator give it sufficiently 'deep pockets' (i.e. sufficient access to finance) to sustain loss making behaviour for a period long enough to eliminate a competitor. Third, whether the dominant undertaking has sufficient capacity to win sales from its rival.

³³ Where an undertaking is in a position of 'super-dominance' (that is, it has a very high degree of market power, which may be inferred, typically, from a market share in the order of 90 per cent), and it selectively cuts prices with the intent of eliminating a competitor, it may be abusing its dominant position even if the discounted prices charged are not loss making. (See Cases C-395 and 396/96P *Compagnie Maritime Belge v Commission* [2000] ECR I-1365, including the opinion of Advocate General Fennelly; Case T-228/97 *Irish Sugar v Commission* [1999] ECR II-2969; and *Napp* at paragraphs 337 to 339.)

Feasibility of recouping losses

- 4.24 A third issue is whether the undertaking, having successfully forced a competitor out of a market, would be able to recoup its earlier losses. If the undertaking would not be able to recoup these losses (e.g. because it would still face competition from existing or potential competitors), the predatory strategy would be unprofitable.
- 4.25 However, the European Court has held that, whenever there is a risk that competitors will be eliminated, there is no need to prove the possibility of recoupment.³⁴ This is because the weakened state of competition on the market on which the undertaking holds a dominant position will, in principle, ensure that losses are recouped.³⁵
- 4.26 Predatory pricing may be pursued in one sector (or market) in order to protect profits or share of sales in another, perhaps through establishing a reputation likely to deter other would-be entrants. This too can be seen as a form of recoupment.³⁶

Relation to other parts in this guideline

- 4.27 Some of the principles discussed in this part are relevant to the analysis of anti-competitive behaviour discussed in other parts of this guideline.³⁷ For example, there may be cases where low prices are not aimed at the elimination of a competitor but at protecting a market from a potential competitor or at weakening a competitor in a way that impedes existing competition. This is discussed further in Part 5.³⁸

³⁴ Tetra Pak II, endorsed by the CAT in *Aberdeen Journals (No. 2)* at paragraphs 441 to 446.

³⁵ Where the competitor at risk of elimination is a competitor in a market other than that in which the dominant position is held (that is to say, an associated market) then the OFT may, depending on the circumstances of the case, specifically consider the feasibility of recouping losses.

³⁶ See *Aberdeen Journals (No. 2)* at paragraph 445.

³⁷ This guideline does not address cross-subsidies and subsidies specifically. Where a dominant undertaking subsidises its prices this will be an abuse only if this harms (or is likely to harm) competition. Subsidies will be assessed on a case by case basis. Usually the issue will be whether the subsidised price is predatory.

³⁸ Technical issues such as those to do with measuring and allocating costs and revenues are relevant to predation as well as cases of alleged margin squeeze, excessive pricing, and discounts which may foreclose markets.

5 DISCOUNTS

Introduction

- 5.1 The offering of discounts to customers is an important form of price competition and is therefore generally to be encouraged. Competition law should not deter beneficial price competition, so evidence that a discount scheme harms (or is likely to harm) competition is needed before that discount scheme will be found to be abusive.³⁹
- 5.2 When assessing the effect of a dominant undertaking's discount scheme on competition, it is often important to consider whether the scheme is commercially rational only because it has the effect (or likely effect) of foreclosing all, or a substantial part, of the market that is open to competition.⁴⁰
- 5.3 It must also be considered that a dominant undertaking's discount scheme may reflect competition to secure orders from valued customers or have beneficial effects. For example, it may:
- expand demand and thereby help cover fixed costs efficiently;
 - lower input costs for downstream undertakings and thereby encourage them to compete more effectively on price;
 - reflect efficiency savings resulting from supplying particular customers; or
 - provide an appropriate reward for the efforts of downstream undertakings to promote a dominant undertaking's product.

³⁹ Discounts, when employed by an undertaking in a dominant position, can impair genuine undistorted competition and thereby be abusive. See Case 322/81 *Michelin v Commission* [1983] ECR 3461 (**Michelin**).

⁴⁰ As part of this analysis, it may be relevant to consider whether there were alternative discount schemes that would achieve similar commercial benefits but without harming (or being as likely to harm) competition.

5.4 The following sections consider the following types of discount scheme: volume discounts, fidelity rebates and loyalty discounts, and multi-product rebates. The various schemes are described according to their forms, but it is important to bear in mind that it is the effect on competition of any particular scheme, rather than its form, which will determine whether or not it is abusive.

Volume discounts

5.5 Volume discounts mean that customers obtain bigger discounts as the size of their order increases. Volume discounts may often be benign. They may reflect efficiencies associated with supplying large orders to customers or, for example where a distributor sells to a retailer, may be a legitimate way to provide incentives for the retailer to promote the distributor's product. However, volume discounts may also harm competition where they have exclusionary effects.

Fidelity rebates and loyalty discounts

5.6 Fidelity rebates and loyalty discounts (which are used interchangeably here) arise where a supplier (e.g. a manufacturer) effectively offers a customer (e.g. a wholesaler or a retailer) a discount that is conditional not on the size of the customer's order, but on the share of the customer's needs purchased from the supplier.⁴¹ Thus, provided a small customer purchases most of its requirements from a supplier, it may obtain the same discount as a very large customer, even though the amounts purchased may vary significantly.⁴²

5.7 Various discount schemes could have a 'loyalty inducing effect'. For example, consider a growth rebate whereby the customer obtains a

⁴¹ For example, suppose a large customer typically purchases 1000 units, while a small customer typically purchases 100 units. If a discount is offered to customers only when they purchase 80 per cent of their needs from a dominant undertaking, the large customer must purchase at least 800 units to obtain the discount while the small customer must purchase only 80 units.

⁴² A commonly cited definition of a fidelity rebate is taken from the European Court's judgement in Case 85/76 *Hoffman-La Roche v Commission* [1979] ECR 461 (**Hoffmann-La Roche**) at paragraph 89: '...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'. A dominant undertaking pricing according to a system of fidelity rebates may also be engaging in price discrimination. Price discrimination is discussed in Part 3 of this guideline.

substantial discount only if it increases the amount purchased from a supplier by 10 per cent on purchases made the previous year. If the natural growth in the customer's market is insufficient to require such an increased volume, this sort of discount may provide an incentive for the customer to increase its purchases from (or its 'loyalty' for) this supplier at the expense of others. The same applies for target rebates, where a customer does not qualify for a rebate unless it sells at least the targeted amount of the supplier's product. If the rebate is substantial and the target is set close to the customer's total input requirement, it has a 'loyalty inducing effect' as the customer would be encouraged to increase purchases from the supplier at the expense of others.⁴³

- 5.8 Fidelity rebates may be abusive where they lead to foreclosure effects. It is the 'loyalty inducing effect' of a fidelity rebate that generally raises potential competition concerns.⁴⁴ However, even where a discount scheme adopted by a dominant undertaking has a loyalty inducing effect, the scheme would not be found abusive if it did not (or was not likely to) harm competition.

Multi product discounts

- 5.9 Multi-product discounts occur where a discount on one product is obtained when a customer purchases sufficient quantities of another. For example, if an undertaking is dominant in the market for product A, it might offer customers discounts on their purchases of another product, B, based on their purchases of product A.

⁴³ This is not to suggest that growth and target rebates always have loyalty inducing effects, only that in some circumstances they can have a similar effect to fidelity rebates. Setting discounts dependent on dealers meeting sales targets based on their previous year's sales can be abusive, as the European Court found in Michelin.

⁴⁴ In the extreme, a fidelity rebate scheme might provide a strong incentive for a customer to deal exclusively with a dominant supplier. Exclusive purchasing is discussed in Part 7.

- 5.10 Since customers pay different prices for product B depending on how much they also buy of product A, multi-product discounts are often a form of price discrimination (unless the price differences reflect cost differences). As with price discrimination in general (see Part 3), a multi-product discount scheme offered by a dominant undertaking may have beneficial, exploitative or exclusionary effects and so must be assessed on a case-by-case basis.
- 5.11 Mixed bundling is an example of a multi product discount. Mixed bundling refers to the situation where two or more products are offered as unbundled (i.e. undiscounted) products and simultaneously offered together at a price less than the sum of the individual product prices (i.e. discounted).
- 5.12 Conceptually, the analysis of the foreclosure effects of multi product discounts is often similar to that for single product discounts. In both cases, it may be important to consider whether the scheme is commercially rational only because it has the effect (or likely effect) of foreclosing all, or a substantial part, of the market(s) that is (are) open to competition.
- 5.13 A multi product discount scheme adopted by a dominant undertaking would not be abusive if the scheme did not (or was not likely to) harm competition.⁴⁵

⁴⁵ While the analysis of bundling will generally focus on potential foreclosure effects, it is possible for bundling to be used as a way to exploit customers through charging excessive prices. Excessive prices are considered in Part 2.

6 MARGIN SQUEEZE

Introduction

6.1 A margin squeeze⁴⁶ may occur in an industry where a vertically integrated undertaking is dominant in the supply of an important input for a downstream market in which it also operates. The vertically integrated undertaking could then harm competition by setting such a low margin between its input price (e.g. wholesale price) and the price it sets in the downstream market (e.g. retail price) that an efficient downstream competitor⁴⁷ is forced to exit the market or is unable to compete effectively.⁴⁸

Testing for margin squeeze

6.2 To test for margin squeeze, it is usual to determine whether an efficient downstream competitor would earn (at least) a normal profit when paying input prices set by the vertically integrated undertaking.⁴⁹

6.3 In practice, in order to determine whether an efficient downstream competitor would make a normal profit, the test is typically applied to the downstream arm of the vertically integrated undertaking. Therefore, the test asks whether, given its revenues at the time of the alleged margin squeeze, the integrated undertaking's downstream business would make (at least) a normal profit if it paid the same input price that it charged its competitors.⁵⁰

6.4 A test for margin squeeze might require assessing the accounts of a 'notional business'⁵¹ as in practice the integrated undertaking's

⁴⁶ A margin squeeze (as defined in this part) is sometimes called price squeeze.

⁴⁷ i.e. a competitor that would act as a competitive constraint on the dominant undertaking's downstream arm, but for the margin squeeze.

⁴⁸ For a similar description see competition law guideline *The application of competition law in the telecommunications sector* (OFT417), paragraph 7.26 and Case T-5/97 *Industrie des poudres sphériques SA v European Commission* [2000] ECR II-3755, paragraph 178.

⁴⁹ See, for example, Case T-5/97 *Industrie des poudres sphériques SA v Commission* [2000] ECR II-3755 at paragraph 178 and *Napier Brown/British Sugar*, OJ [1988] L284/41 at paragraph 66 and *National Carbonizing Company Limited* OJ [1976] L35/6 at paragraph 7.

⁵⁰ See also competition law guideline *The application of competition law in the telecommunications sector* (OFT417), paragraph 7.26.

⁵¹ i.e. a business operation for which there are no separate accounts.

downstream business may not have separate accounts from its upstream business and would not usually treat its input prices as a cost in the same way that an independent downstream competitor would. Therefore, the details of how costs and revenues are allocated and/or calculated will depend on the circumstances of each case. For example, a margin squeeze investigation may raise issues such as the measurement and allocation of costs and revenues (both between products and between upstream and downstream operations), the appropriate rate of return, and the appropriate time period over which to measure profitability.

Margin squeeze as an abuse of a dominant position

- 6.5 If there is evidence that a vertically integrated dominant undertaking has applied a margin squeeze and that it harmed (or was likely to harm) competition, this is likely to constitute an abuse of that dominant position.

7 VERTICAL RESTRAINTS

Introduction

- 7.1 In general, vertical restraints are provisions made between undertakings operating at different levels in the supply chain which restrict the commercial freedom of one or more parties to the agreement. This part sets out some of the factors that the OFT would consider when assessing whether a vertical restraint imposed by a dominant undertaking infringes Article 82 and/or the Chapter II prohibition.⁵²
- 7.2 A vertical restraint might be an agreement between a manufacturer and a retailer, a manufacturer and a wholesaler, a wholesaler and a retailer, a retailer and an end customer or between two manufacturers (or wholesalers or retailers) which, for the purposes of the agreement, operate at different stages in the supply chain.

Types of vertical restraint

- 7.3 The following list provides examples of vertical restraint that may be considered under Article 82 and/or the Chapter II prohibition (the list is not exhaustive):⁵³
- **exclusive purchasing or dealing:** where the retailer is required to purchase, or deal in, goods from only one manufacturer;
 - **tie-in sales and bundling:** where the manufacturer makes the purchase of one product (the tying product) conditional on the purchase of a second product (the tied product). A set of tied products is sometimes referred to as a bundle of products;⁵⁴

⁵² Vertical agreements may also be assessed under Article 81 and/or the Chapter I prohibition. Whether addressed in that context or under Article 82 and/or the Chapter II prohibition, the economic analysis will often be similar. Competition law guideline *Vertical agreements* (OFT419) describes the economic analysis of vertical agreements in greater detail.

⁵³ Although the examples refer only to restraints affecting manufacturers and retailers, the same principles apply to restraints affecting other parts of the supply chain.

⁵⁴ For example, products A and B are bundled when the price of A or the opportunity to purchase A is conditional on the quantity of B that is purchased.

- **full-line forcing:** a form of tie-in sale where, in order to obtain one product in the retailer's range, the retailer is required to stock all the products in that range;
- **quantity forcing:** where, in order to obtain a product, the retailer is required to purchase a minimum quantity of that product.

7.4 Selective distribution, exclusive distribution and resale price maintenance agreements are also vertical restraints. While these restraints may be assessed under Article 82 and/or the Chapter II prohibition, they are more likely to be assessed under Article 81 and/or the Chapter I prohibition (see competition law guideline *Vertical agreements* (OFT419)).

Competition effects

7.5 The important issue is generally not the form of the vertical restraint but its effect on competition. A vertical restraint imposed by a dominant undertaking may be abusive where its (likely) effect is to foreclose (a substantial part of) a market to potential or existing competition or to dampen competition. The following paragraphs provide some examples.⁵⁵

Example of foreclosure

7.6 Where a dominant manufacturer agrees an exclusive purchasing requirement with a retailer, this is likely to amount to an abuse. This is so whether the initiative for the exclusivity obligation came from the manufacturer or the retailer.⁵⁶

7.7 Depending on the circumstances, other vertical restraints may have a similar effect to exclusive purchasing agreements. For example, a dominant manufacturer might require that its retailers purchase a minimum quantity of its product. If the minimum quantity is set close to

⁵⁵ While these examples refer to restraints imposed by a dominant manufacturer on one or more retailers, similar issues may arise where a dominant retailer imposes vertical restraints on its suppliers. For example, if a dominant retailer requires that its suppliers do not sell to other retailers, this may weaken the intensity of competition in the retail market.

⁵⁶ Hoffmann-La Roche at paragraph 89.

each retailer's total input requirement, the effect is *de facto* exclusive purchasing.⁵⁷

- 7.8 A dominant manufacturer's exclusive purchasing agreements (or vertical restraints with similar effect) will not necessarily be found abusive. For example, the specific circumstances of the case may indicate that the agreements do not (or were not likely to) harm competition.

Example of competition dampening

- 7.9 Where a dominant manufacturer requires that its retailers give it the opportunity to match any price offered by a rival, this might dampen inter-brand competition (i.e. competition among manufacturers) by reducing the rival's incentive to compete on price. However, there may be no effect on competition if only a small proportion of the retail market is subjected to this restraint.

Benefits of vertical restraints

- 7.10 While vertical restraints imposed by a dominant undertaking can lead to anti-competitive effects, they may also produce economic benefits. For example, vertical restraints can generate benefits through:

- promoting efficiencies
- promoting non-price competition, and
- promoting investment and innovation.

- 7.11 These benefits (which are discussed in detail in the competition law guideline, *Vertical agreements* (OFT419)) may be relevant when assessing whether a vertical restraint imposed by dominant undertaking is abusive.

⁵⁷ Full-line forcing and tying agreements may also be structured in a way that leads to *de facto* exclusive purchasing. In addition, a dominant manufacturer may offer a discount to retailers that purchase exclusively. This can be analysed in a similar way to a fidelity rebate (see Part 5).

Case by case assessment of vertical restraints

7.12 As noted above, the important question in relation to a vertical restraint is not what form it takes but what effect it has on competition. Even vertical restraints imposed by dominant undertakings may produce benefits and will not necessarily harm competition. Vertical restraints are therefore generally assessed on a case by case basis.⁵⁸

⁵⁸ A case by case approach is not, however, necessary for vertical restraints having as their object the prevention, restriction or distortion of competition, such as vertical restraints which directly or indirectly restrict a customer's ability to determine its sale price. See the competition law guideline *Vertical agreements* (OFT419).

8 REFUSAL TO SUPPLY AND ESSENTIAL FACILITIES

Refusal to supply

- 8.1 Undertakings are generally free to supply, or not to supply, to whomever they choose. Therefore, refusal to supply by a dominant undertaking is not normally abusive. In some circumstances, a refusal to supply may be considered to be abusive and a dominant undertaking's freedom to contract with whomever it chooses may be circumscribed. This would occur only if there is evidence of (likely) substantial harm to competition and if the behaviour cannot be objectively justified.
- 8.2 A refusal to supply occurs where an undertaking stops supplying an existing customer⁵⁹ or withholds supplies from a new customer. A refusal to supply by a dominant undertaking is more likely to be considered an abuse where it results in the elimination of competition⁶⁰ or stifles the emergence of a new product.⁶¹ A refusal to supply could result from a refusal to allow access to an essential facility (discussed below), although in practice essential facilities are rare.
- 8.3 Behaviour which has the same effect as a refusal to supply could also constitute an abuse (sometimes called 'constructive' refusal to supply). For example, a dominant undertaking might supply at such a high price,⁶² or at such an inferior level of quality, that customers would effectively be prohibited from purchasing.
- 8.4 Refusal to supply might on occasion result from a vertical restraint. A manufacturer imposing a selective distribution system, for example, would, by definition, be refusing to supply outlets which were not within the system. Such cases would be considered as set out in Part 7, above, on vertical restraints and/or the competition law guideline *Vertical agreements* (OFT419).

⁵⁹ United Brands and Case 311/84 CBEM v CLT and IPB [1985] ECR 3261.

⁶⁰ Cases 6 & 7/73 Instituto Chemioterapico Italiano SpA & Commercial Solvents Corp v Commission [1974] ECR 223, [1974] 1 CMLR 309.

⁶¹ Cases C-241 & 242/91 RTE and ITP v Commission [1995] I ECR 743, [1995] 4 CMLR 718, which involved the refusal to license copyright. In general refusal to license an intellectual property right is not an abuse. Examples of the exceptional circumstances where it will be are described in the competition law guideline *Intellectual property rights* (expected 2004).

⁶² Excessive prices are discussed in Part 2.

An essential facility

- 8.5 Although the assessment of whether a particular facility is essential must be on a case-by-case basis, in practice essential facilities are rare. A facility will only be viewed as essential where it can be demonstrated that access to it is indispensable in order to compete in a related market and where duplication is impossible or extremely difficult owing to physical, geographic or legal constraints (or is highly undesirable for reasons of public policy). In certain cases, the cost of duplicating the facility might also be regarded as an insuperable obstacle.⁶³ While potential examples include ports and utility distribution networks (for example, electricity wires, and water and gas pipelines), in practice few facilities can be described as being truly essential. Intellectual property rights by themselves are unlikely to create essential facilities in normal circumstances.
- 8.6 Market definition is a crucial part of the determination of whether a particular facility is essential. An asset will not be regarded as an essential facility if other similar facilities compete within the same relevant market (i.e. if there are potential substitutes), or if the facility is not indispensable to the provision of the good or service in question. For example, a port will not be regarded as an essential facility if other ports compete within the same geographic market (see the competition law guideline *Market definition* (OFT403)).

Access to essential facilities

- 8.7 As with refusal to supply in general, refusal to allow access to an essential facility will constitute an abuse only if there is evidence of (likely) substantial harm to competition (e.g. in a related market) without an objective justification for the dominant undertaking's behaviour.⁶⁴ Objective justifications could include normal commercial reasons, such as creditworthiness, and might depend on (for example) the lack of available spare capacity within the facility.

⁶³ See the judgment of the European Court in Case C-7/97 *Oscar Bronner v Mediaprint and others*, [1998] ECR I-7791 (**Oscar Bronner**) and in particular the opinion of AG Jacobs, at paragraphs 47 and 65 to 66.

⁶⁴ In order to establish the existence of abuse, the refusal of access to the facility must be likely to eliminate all competition in the market on the part of the person requiring access, without being objectively justified: see, for example, *Oscar Bronner* at paragraph 41.

- 8.8 When determining whether refusal to allow access to an essential facility constitutes an abuse and, if so, on what terms access should be granted, care must be taken not to undermine the incentives for undertakings to make future investments and innovations, especially where the essential facility is a result of a previous innovation.

GLOSSARY OF TERMS

Terms used in a definition which are themselves defined are in bold.

Average avoidable costs (AAC)	An undertaking's total avoidable costs divided by its output.
Average total costs (ATC)	An undertaking's total costs divided by its output.
Average variable costs (AVC)	An undertaking's total variable costs divided by its output.
Avoidable costs	The costs avoided if an undertaking ceases to continue a particular activity (e.g. supplying a particular market) over a specified time period (see Part 4).
Bundling	Products A and B are bundled when the price of A or the opportunity to purchase A is conditional on the quantity of B that is purchased. See tie-in sales , and mixed bundling .
Common costs	Common costs arise where two or more products are produced together even though they could be produced separately (at a higher overall cost). See economies of scope .
Cost of capital	The return required by lenders and shareholders that provide an undertaking with finance.
Downstream	A part of the supply chain closer to final consumers. For example, where manufacturers supply retailers who then sell to final consumers, the manufacturers are upstream undertakings and retailers are downstream undertakings.
Economies of scale	Where average total costs decline as output increases.

Economies of scope	Where the total cost of production is lower if two or more products are produced jointly (for example, by the same undertaking) rather than separately (for example, by two separate undertakings). Economies of scope occur where there are common costs .
Essential facility	A facility to which access is indispensable in order to compete on a related market and duplication of which is impossible or extremely difficult owing to physical, geographic or legal constraints (or is highly undesirable for reasons of public policy). See Part 8.
Exclusive distribution	A particular form of selective distribution where, for example, a manufacturer supplies only one retailer in a particular territory or allows only one retailer to supply a particular class of customer, such as businesses or consumers (see Part 7).
Exclusive purchasing or dealing	Where, for example, the retailer is required to purchase, or 'deal' in, goods from only one manufacturer (see Part 7).
Fidelity discounts	Where, for example, a retailer receives discounts based on the proportion of its sales which come from the manufacturer, or other similar schemes with such loyalty inducing effect (see Part 5). Also called loyalty rebates .
Fixed costs	Costs which do not vary with an undertaking's output over the relevant period (see Part 4).
Full-line forcing	A form of tie-in sale where, in order to obtain one product in the retailer's range, the retailer is required to stock all the products in that range (see Part 7).
Incremental costs	The cost of producing a specified additional product, service or increment of output over a specified time period. Marginal cost is a particular

type of incremental cost where the increment is one unit of output (see Part 4).

Internal Rate of Return (IRR)

Suppose an initial capital outlay was made (e.g. in order to produce a new product) which generates a future stream of cashflows (e.g. profits from sales of the product over its lifetime). The IRR is the discount rate that will equate the **present value** of the stream of expected cashflows to the initial capital outlay (see Part 2).

Joint costs

These arise where producing one product requires producing another product in broadly fixed proportions.

Loyalty rebates

See **fidelity discounts**.

Marginal cost

The cost of producing one additional unit of output over a specified time period (see also **incremental costs**).

Mixed bundling

A situation where two or more products are offered as unbundled (i.e. undiscounted) products and simultaneously offered together at a price less than the sum of the individual product prices (i.e. discounted), see Part 5.

Normal profit

The level of profits that an undertaking requires to provide a sufficient return to the lenders and shareholders that provide the undertaking with capital.

Net present value (NPV)

Suppose an initial capital outlay was made (e.g. in order to produce a new product) which generates a future stream of cashflows (e.g. profits from sales of the product over its lifetime). The NPV is calculated by comparing the initial capital outlay with the **present value** of the resultant cashflows (see Part 2).

Present value

The value obtained when a stream of expected cashflows is discounted by the **cost of capital** rate (see Part 2).

Quantity forcing	Where, for example, in order to obtain a product, the retailer is required to purchase a minimum quantity of that product (see Part 7).
Resale price maintenance (RPM)	Where, for example, the manufacturer specifies the resale price of the product, sometimes referred to in relation to a minimum price (see Part 7).
Selective distribution	Where, for example, a manufacturer supplies only a limited number of retailers who are restricted in their ability to re-sell products and who may have to meet certain standards of service (see Part 7).
Stand-alone cost	The lowest cost which could be faced by a hypothetical supplier of only a particular product or service. Stand-alone costs include all joint costs and common costs (see Part 2).
Sunk costs	Costs which cannot be recovered when an undertaking leaves a market.
Supra-normal profits	Profits higher than an undertaking would earn in the long term in a competitive market, demonstrated by an undertaking's profitability persistently exceeding its cost of capital .
Tie-in sales	Where the manufacturer makes the purchase of one product (the tying product) conditional on the purchase of a second (tied) product. A set of tied products is sometimes referred to as a bundle.
Total costs	The sum of variable costs plus fixed costs .
Upstream	A part of the supply chain further away from final consumers. For example, where manufacturers supply retailers who then sell to final consumers, the manufacturers are upstream undertakings and retailers are downstream undertakings.
Variable costs	Costs which vary with an undertaking's output over a specified time period (see Part 4).