



# **UNILATERAL CONDUCT WORKBOOK CHAPTER 3: ASSESSMENT OF DOMINANCE**

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# ICN UNILATERAL CONDUCT WORKBOOK

## **CHAPTER 3 — Assessment of Dominance**

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## Introduction

1. Two ICN work products provide specific guidance on defining market power and dominance—the Recommended Practices on Dominance/Substantial Market Power<sup>1</sup> and the Report on the Objectives of Unilateral Conduct Laws, Assessment of Dominance/Substantial Market Power, and State-Created Monopolies.<sup>2</sup> They reflect the responses of thirty-five ICN Members and fourteen non-governmental advisors to a UCWG questionnaire and take into account the approaches of competition agencies from around the world.
2. This Chapter of the Workbook seeks to complement the two existing ICN work products on dominance by discussing how to apply the concept of “dominance” in practice, and, in particular, how to use various types of evidence to determine whether or not a firm is “dominant.”<sup>3</sup> The first section will briefly discuss the concept of dominance and its relationship to the notion of market power, including basic approaches ICN members use to define dominance. The following sections discuss in greater detail the analytical frameworks and evidentiary requirements to determine whether a firm can be considered dominant, including defining the relevant product and geographic market, the assessment of entry, and the evaluation of countervailing buyer power.

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

<sup>2</sup> ICN Report on the Objectives of Unilateral Conduct Laws, Assessment of Dominance/Substantial Market Power, and State Created Monopolies, at 2 (“Report”), *available at* <http://internationalcompetitionnetwork.org/uploads/library/doc353.pdf>.

<sup>3</sup> Different jurisdictions use such terms as “substantial market power,” “monopoly power,” or “dominance” to describe a firm that has a high degree of market power that can be maintained for a long duration. *See* Recommended Practices, at 1. In order to avoid confusion, in this Chapter all these terms will be referred to as “dominance.”

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3. Unilateral conduct laws aim to ensure an effective competitive process.<sup>4</sup> An effective competitive process can promote such goals as consumer welfare and economic efficiency, among others.<sup>5</sup> Conduct that may constitute an abuse when performed by a dominant firm can be procompetitive, or competitively neutral, when performed by firms that are not dominant. Alternatively, firms that are not dominant are not likely to succeed in harming the competitive process using that conduct.<sup>6</sup> The requirement for dominance thus serves as a “filter” that allows the laws, and the agencies enforcing them, to focus on conduct that may possibly harm competition.<sup>7</sup>
4. Unilateral conduct laws do not make the possession of dominance unlawful.<sup>8</sup> Nor do they create liability for the acquisition of dominance through competition on the merits.<sup>9</sup> As a result, the assessment of dominance is one part of a larger evaluation of whether a dominant firm has engaged in a form of conduct that constitutes an abuse that harms competition. Some jurisdictions see a finding of dominance as a necessary first step, whereas other jurisdictions regard it as a step that is integrated in the overall assessment of the case in which evaluating the existence of dominance, the conduct at issue, and the anticompetitive effects is part of an integrated process. This Chapter addresses the first component of that evaluation, the existence of dominance, and subsequent chapters of this Workbook will address the evaluation of conduct to determine whether it constitutes an abuse that harms competition.

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<sup>4</sup> Report, at 2.

<sup>5</sup> Report, at 2.

<sup>6</sup> Report, at 40.

<sup>7</sup> Report, at 40.

<sup>8</sup> Recommended Practices, at 1; Report, at 40.

<sup>9</sup> Recommended Practices, at 1; Report, at 40.

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### I. The Concept of Dominance and its Relationship with Evidentiary Requirements

#### A. Dominance and Substantial Market Power

5. There is broad consensus among ICN members that market power is “the ability to price profitably above the competitive level.”<sup>10</sup> The ability to maintain supra-competitive prices is used as shorthand for the various ways in which market power can be exercised, including non-price effects such as reductions in product quality or innovation.
6. Although each jurisdiction has its own specific wording for the legal definition of the concept of dominance, it generally requires a “high degree of market power both with respect to the level to which price can be profitably raised and to the duration that price can be maintained at such a level.”<sup>11</sup> Dominance thus requires that market power be *substantial* and *durable*. If the exercise of market power is only temporary and can be remedied by market forces in a reasonable time, a firm is not dominant. Dominance can also be described by a firm’s ability to behave with appreciable freedom from competitive discipline imposed by rivals.<sup>12</sup>
7. These concepts of dominance do not provide a bright line test to distinguish instances of “normal,” “every-day” market power that falls below the threshold of unilateral conduct laws from instances where a firm is dominant. In fact, assessing dominance is a demanding task; it requires analytical discipline and certain determinations based on considered and developed judgment, consistent with a competition regime’s policy

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<sup>10</sup> Recommended Practices, at 1.

<sup>11</sup> Recommended Practices, at 1. In some jurisdictions the dominance definition also applies to several companies possessing market power jointly, called “collective dominance.” However, this Workbook addresses only single-firm conduct, not collective dominance.

<sup>12</sup> Report, at 40-41.

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objectives. The degree of market power required to constitute dominance and the nature and extent of the evidence required to establish dominance are basic and important policy choices made by legislatures, competition agencies, and courts.<sup>13</sup>

8. By highlighting that market power must be substantial and durable and that a firm must enjoy appreciable freedom from competitive discipline imposed by rivals, these concepts of dominance provide a useful analytical framework. In particular the framework assists in identifying evidence that is relevant in the dominance assessment and it explains why certain types of evidence may be more useful than others. For example, when entry is easy, market power is likely not durable; this explains why entry barrier analysis is considered one of the most important steps in the assessment of dominance (or the absence thereof).

### **B. Legal Approaches to Finding Dominance**

9. Jurisdictions define dominance in different ways. Many jurisdictions emphasize behavioral aspects in their definitions of dominance and focus on the extent of a firm's competitive constraints or ability to act in ways that a competitively constrained firm could not.<sup>14</sup>
10. Other jurisdictions focus on structural elements in their definition of dominance. Typically they define dominance primarily or exclusively by an established market share

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<sup>13</sup> Recommended Practices, at 1.

<sup>14</sup> *See* Report, at 41. Throughout Europe, the measure of competitive constraints is often expressed by “independence” from such constraints. Several other jurisdictions refer instead to the (price-raising) effects of market power.

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threshold, although in some of those jurisdictions market share analysis can be an initial step that allows for situation-specific deviations.<sup>15</sup>

11. The different approaches to the legal definition of dominance do matter. A greater focus on behavioral aspects in defining dominance has the advantage of encouraging a multi-faceted analysis, which, as the Recommended Practices explain, is more appropriate given that a broad range of factors can determine whether a firm's market power reaches the requisite levels of substantiality and durability.<sup>16</sup> Conversely, a definition of dominance that focuses on market share may not be sufficiently flexible to take into account relevant features of the market, such as easy entry or intense rivalry based on rapid technological development, that suggest a firm may not be able to exercise market power durably despite a high market share.<sup>17</sup> Thus, there might be a greater risk that the finding of dominance is disconnected from the existence of substantial and durable market power.
12. Yet, the impact of these definitional differences should not be overestimated. Previous surveys have confirmed that ICN members use similar types of evidence in their dominance assessment.<sup>18</sup> Market definition and assigning market shares is invariably part of this analysis.
13. The applicable legal definition of dominance might therefore matter less than the differences in language suggest. What matters is that the competition authority develops a robust explanation for why all the available evidence supports a finding that a firm's

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<sup>15</sup> See Report, at 42.

<sup>16</sup> See Recommended Practices, RP 2 & cmt. 2.

<sup>17</sup> See Recommended Practices, RP 3 cmt. 2.

<sup>18</sup> Report, at 43-44.

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market power is substantial and durable, i.e., that the firm acts with appreciable freedom from competitive discipline imposed by rivals.

14. The ultimate goal of a unilateral conduct case is to determine whether certain conduct harms competition. Assessing dominance is one important element in this analysis, and should be performed carefully. However, dominance is not the only element in a unilateral conduct case, and analyzing conduct and assessing dominance should therefore not be two totally separated steps in the analysis of a unilateral conduct case, nor is it necessary for the steps to be performed sequentially. Evidence used to assess dominance should inform the analysis of conduct and its anticompetitive effects, and vice versa.
15. Before concluding that a firm possesses dominance in a market, an agency should undertake a comprehensive consideration of all relevant factors affecting competitive conditions in that market.<sup>19</sup>
16. Evidence related to dominance can be divided into direct evidence and indirect evidence. Direct evidence attempts to draw inferences from the firm's performance, such as pricing or profitability, within the market.<sup>20</sup> However, direct evidence to assess dominance may be limited by the difficulty of obtaining meaningful data. In addition, using direct evidence faces the challenge of the absence of objective thresholds to make meaningful conclusions about dominance.
17. By comparison, indirect evidence attempts to draw inferences of dominance mainly from the structure of the market. Market shares, entry conditions, and other market factors all affect a firm's ability to exercise market power.

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<sup>19</sup> Recommended Practices, RP 2.

<sup>20</sup> Other forms of direct evidence relevant to such issues as intent and conduct are not discussed here.

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### II. Defining the Relevant Market

18. Defining a relevant market generally provides a good starting point for the assessment of dominance, as it helps an agency to understand the scope of competition and the competitive constraints that limit a firm's ability to exercise market power.<sup>21</sup>
19. Analyzing the information required to determine a relevant market helps an agency develop a framework in which to assess the conduct of concern. Defining a relevant market also helps the agency understand the respective positions of rival firms, competitive interactions among them, and the constraints a firm's customers impose. Thus the information gathered and steps taken to define a relevant market are also highly useful in assessing the effects on competition from the alleged abuse.

#### A. The Relevant Product Market

20. Defining a relevant market usually starts by identifying economic substitutes from the point of view of the customers, or "demand side substitution." It also takes into account the ability of suppliers to use existing capacity to begin producing the allegedly dominant firm's product or a close substitute to it, or "supply side substitution." The analysis is essentially the same for the product dimension and the geographic dimension of the relevant market.
21. When a relevant market can be defined with some accuracy, market share provides an initial indicator of whether a firm has market power and its degree of power.<sup>22</sup>

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<sup>21</sup> See Recommended Practices, RP 3 & RP 3 cmts. 1-2.

<sup>22</sup> Recommended Practices, RP 3 cmt. 1.

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### 1. Demand-side Substitutability

22. When defining the relevant product market, demand side substitution possibilities respecting the alleged dominant firm's product are critical. The ability of customers to switch to rival products is generally the most direct and most effective competitive constraint and therefore the most relevant factor in defining a relevant product market.
23. Defining the relevant market entails identifying the set of products that are substitutable from the point of view of consumers. If a sufficiently large number of consumers view a product's substitutes as presenting a reasonable alternative, significant market power cannot be exercised with respect to that product alone.<sup>23</sup> Competition authorities can use qualitative methods to assess substitutability (focusing, for example, on product characteristics and use) and quantitative methods which rely on empirical methods to measure substitutability.
24. The most commonly used method of assessing demand-side substitution is the hypothetical monopolist test. Starting with the alleged dominant firm's product, this test asks whether, in response to a small but significant and non-transitory increase in price ("SSNIP") for this product, a sufficient number of customers would switch to other products such that the dominant firm would not impose the price increase. If so, the product market must be expanded to include one or more additional substitutes. This iterative process continues until a group of products is identified for which a hypothetical monopolist selling those products could profitably raise the price significantly.<sup>24</sup>

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<sup>23</sup> See ICN Merger Guidelines Workbook ("Merger Workbook"), at A.16, available at <http://internationalcompetitionnetwork.org/uploads/library/doc321.pdf>

<sup>24</sup> See Merger Workbook, at A.16.

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25. In defining the market for the purpose of assessing dominance, it is important to consider whether the alleged dominant firm is already selling its product at or near the “monopoly” price. If the firm is dominant, it already is presumably extracting a monopoly profit. Therefore, in this situation, the fact that a further price increase might not be profitable does not indicate that demand-side substitution is constraining prices at a competitive level. Mistakenly concluding that it does is commonly called the “Cellophane fallacy.”<sup>25</sup>
26. The hypothetical monopolist test sometimes can be useful in dominance cases if the switching behavior of customers is assessed at the price level that would prevail in the absence of the alleged anticompetitive conduct. But in many cases it is challenging for a competition authority to determine the “otherwise prevailing” price level. Competition authorities should therefore use the hypothetical monopolist test in unilateral conduct cases with care and recognition of its limitations.
27. Thus, a fundamental challenge with market definition in dominance cases is the absence of a generally accepted tool for defining the relevant market for a firm that already is exercising significant market power.<sup>26</sup>
28. Agencies can and should use a variety of sources in the process of considering demand-side substitution. These sources include:

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<sup>25</sup> See William F. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 960-61 (1981) (describing the analytical error in *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377 (1956)).

<sup>26</sup> For a fuller discussion of this problem, see OECD Competition Policy Roundtables – *Evidentiary Issues in Proving Dominance*, DAF/COMP(2006)35, at 28 (Oct. 9, 2008), available at <http://www.oecd.org/dataoecd/42/8/41651328.pdf>.

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- Evidence on characteristics and usage of the products (e.g., consumer surveys, market research, and trade publications).
- Internal documents (e.g., market studies or strategy documents) of the firm or its competitors.
- Patterns in price changes of the products, in particular price changes and switching patterns before the alleged anticompetitive conduct started.
- The ability to price discriminate, which can suggest a relevant product market defined in part by users of the product. If the seller of the product is able to price differently among customer segments, it may be possible to exercise substantial market power with respect to one or more specific customer segments.

### 2. Supply-side Substitutability

29. The ability of a firm to exercise substantial market power also can be constrained by substitution on the supply side of the market. Supply-side substitutability refers to switching existing capacity from the production of another product to the production of the allegedly dominant firm's product or a close substitute in response to an increase in the alleged dominant firm's prices.
30. Supply substitution is an integral part of an assessment of dominance, and it can be considered as part of market definition. Alternatively, the relevant market could initially be defined strictly on the basis of demand-side substitution, and supply-side substitution could be used to help identify additional participants in a relevant market.

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31. In most instances, the resulting list of competitors in the market and their market shares both should be the same either way. The agency should determine whether firms would find it profitable to respond to a dominant firm's price increase by quickly, and without significant costs or risk, providing new or additional production into the relevant market.<sup>27</sup> If so, that capacity should be included in the relevant market, and those firms should be considered market participants. Of course, the Cellophane fallacy problem applies here as well: If supply-side responses are evaluated at a price resulting from the exercise of substantial market power, the supply substitution may not really be an important constraint.
32. Agencies may be able to evaluate supply-side substitution through interviews with potential suppliers, who may be asked whether substitution is technically possible, the costs involved (including revenue forgone by redeploying facilities used for other purposes), and the time needed to provide additional supply. In addition, evidence of actual shifts in capacity in response to price changes in the past may demonstrate whether supply-side substitution by other firms is likely.

### 3. Other Challenges in Product Market Definition

33. Properly defining a relevant market can be particularly difficult when the products at issue are "differentiated." Such products are viewed by consumers as close, but not

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<sup>27</sup> The difference between a quick supply response and a longer term response that requires significant investment, and generally a longer time period, distinguishes supply responses treated as supply substitution from supply responses treated as entry. As explained in the Mergers Workbook:

[S]upply-side substitutability can be thought of as a special case of entry. Indeed, a number of jurisdictions conduct supply-side analysis as an integral part of the entry assessment rather than as part of defining the market. Whichever approach is taken should not affect the overall analysis of the impact of the merger on competition. In the case of supply-side substitutability, 'entry' occurs quickly, effectively (on a scale large enough to affect prices), and without the need for significant sunk investments.

Mergers Workbook, at A.20.

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perfect, substitutes, as compared with “homogeneous” products that are covered in a more standard analysis. No bright lines may separate the products in any candidate market from a product just outside it.

34. The principal challenge in defining relevant markets characterized by differentiated products is evaluating the degree to which particular firms and their products act as competitive constraints on each other. The smaller a relative price change between the allegedly dominant firm’s price and the price of another product needed to cause significant consumer switching, the more that product acts as a competitive constraint. Among the factors that affect product substitutability are brand loyalty and reputation.
35. Differentiated products can lead to especially narrow product markets, and several incumbent firms may be able to exercise market power within a single market even though none is dominant. Accordingly, investigation into other significant factors constraining the exercise of market power, including supply-side substitution and entry, is important before concluding that a particular firm is dominant.
36. Markets involving high-technology products, where rapid innovation and significant changes in the market occur with frequency, can also present challenges for defining a relevant product market. Defining product markets in this industry calls for careful consideration of how these dynamic characteristics may affect the relevant product market.

### **B. The Relevant Geographic Market**

37. In determining the geographic dimension of the relevant market, an agency should apply the same principles that are relevant to determine the relevant market’s product

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dimension. The question is whether consumers would substitute the relevant product of suppliers in other geographic areas in sufficient volume to constrain the exercise of market power by a hypothetical monopolist.

38. The geographic market can denote the location of suppliers in the market and encompass the region from which sales are made. This often will be appropriate when customers receive goods or services at the supplier's location. Alternatively, the geographic market can be defined based upon the location of customers in the market (or the region into which sales are made). This will typically be appropriate when the hypothetical monopolist can discriminate based on customer location.
39. If an agency determines that the hypothetical monopolist can price discriminate based on the customer's location, it may find it appropriate to define geographic markets around the location of the targeted customers. All sales of a given product to customers in that region would be part of the relevant market. Price discrimination cannot be sustained if either the customers or third parties could "arbitrage," i.e., profitably purchase the product where the price is low and transport it to where the price is high.
40. Using a hypothetical monopolist test to answer questions about substitution between different geographic areas has the risks discussed regarding the relevant product market. If a firm already is exercising significant market power, substitutability at prevailing prices does not suggest that sales in different geographic areas are effective competitive constraints.

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41. The following factors may be significant in defining the relevant geographic market for the unilateral conduct analysis:<sup>28</sup>

- Transportation costs in relation to the value of the product. The higher the value of a product relative to its transportation costs, the more likely customers are to travel further in search of cheaper supplies and the more likely suppliers located in other areas are willing to start supplying into the area. Geographic markets are often very narrow for retail consumer products. For wholesaling and manufacturing markets, lower transportation costs relative to product price may put customers in a better position to switch between suppliers in different regions.
- Whether consumers require a local presence in order for the firm to be considered a viable supplier;
- Whether national or regional regulatory or licensing authorizations are necessary. The need to obtain regulatory approval or some form of license may prevent easy importation and exportation of products and hence the geographic scope would be national or regional.
- Whether geographically limited intellectual property rights prevent imports.
- Whether a company must have a presence in the country where its customers are located to have a full understanding of national legal or regulatory requirements.

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<sup>28</sup> See Merger Workbook, at A.29.

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- Whether import duties or anti-dumping quotas may limit the geographical scope of a relevant market by raising the costs of suppliers from outside of a particular jurisdiction, or other trade barriers, such as “buy national,” are in place.
- Whether there are any language barriers that may prevent cross-border trade.

### **C. Obtaining Relevant Information Regarding the Relevant Market**

42. Obtaining reliable information specific to the relevant product and geographic market may be difficult in some circumstances. Agencies may wish to consider using both private and public sources to obtain the necessary information for an investigation. In this regard, during the investigative process, agency staff will often have to seek data from many of the participants in the market.
43. Information from the alleged dominant firm will necessarily be required. Such information, in addition to hard sales or capacity data, will generally include business plans, financial records, internal market analyses, and other relevant documents. This information is likely to be helpful for assessing which firms (if any) the alleged dominant firm considers to be its actual or potential competitors. Foreign firms or importers may be contacted to determine whether they can provide products in the same market, and whether there are any trade regulations or other barriers preventing them from doing so.<sup>29</sup>

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Agencies should take care to ensure that their cross-border inquiries comply with applicable laws, regulations, and relevant treaties or other agreements. See ICN Recommended Practices for Merger Notification Procedures, at 29, available at <http://www.internationalcompetitionnetwork.org/uploads/library/doc588.pdf>.

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44. Information obtained from customers can also be valuable. Inquiries to customers may concern the characteristics, prices, functions, and usage of the products in question, as well as feasible substitutes and alternative suppliers. Consumers may be asked whether they would be willing and able to switch to another supplier, and the time and costs associated with switching. Well-designed consumer surveys may be an appropriate investigative tool when consumers are sufficiently numerous to allow for robust results.
45. Agencies may also consider publicly available information such as market research reports, trade publications, and academic papers. Many of these documents are available online from a variety of research institutes, consulting firms, and other content providers. Trade associations, regulatory bodies, and government agencies may also provide a source of information about applicable industry standards, statutes, and regulations.
46. In considering whether a firm is dominant, it may be beneficial to look at previous investigations involving that firm or the industry in which it operates.<sup>30</sup> An agency may draw on both its own experience and on the experiences of other jurisdictions. However, in doing so, agencies may need to determine whether the circumstances of those prior investigations are analogous to the current situation. Market conditions and competition dynamics change over time, and such changes may affect a finding of dominance. For example, a firm may have enjoyed a monopoly position in a market due to government regulations preventing access by other firms to facilities needed to offer services in that market. If these restrictions have since been removed, then the firm may face

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<sup>30</sup> See Merger Workbook, at A.10.

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competitive discipline from new entrants. Similarly, competition conditions in one particular country may not necessarily apply to another country.<sup>31</sup>

### **D. Conclusions**

47. In conclusion, market definition is an important step in dominance cases, but it provides challenges for competition authorities. Agencies must cope with incomplete information even after carefully gathering whatever is available. The process involves reasoned, even if not definitive, decisions on what to include in and exclude from the relevant market; potential limitations in dominance cases of the most commonly used methodology for market definition; and the possibility of rapid technological changes and introduction of new products that would expand or contract the relevant market within a short duration.
48. Just because market definition is difficult, however, does not mean that it should not be undertaken. But account should be taken of the process in which the relevant market was established. The greater the uncertainty in defining the relevant antitrust market, the less likely it is that the relevant market is a proper reflection of existing competitive constraints and the less weight should be given to market share as an indicator of market power relative to other factors.
49. In addition, as an agency gains a better understanding of competitive conditions in the course of an investigation, it should be willing to go back and reconsider its initial assessment of the relevant market.

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<sup>31</sup> Merger Workbook, at A.10.

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### III. Assigning and Interpreting Market Shares

50. An important part of an indirect assessment of dominance is the market share of the potentially dominant firm. Market share is the most widely used indicator in an initial assessment of a firm's market power,<sup>32</sup> and of the extent to which the firm's market power is limited by competition.<sup>33</sup>
51. Market share can be a reliable indicator of market power only if the agency has confidence in its definition of the relevant market. A conclusion that dominance exists should not be reached based on market shares alone.<sup>34</sup> Agencies should avoid over-emphasizing market shares in the analysis of dominance at the expense of other factors.<sup>35</sup> If entry and expansion are easy, for example, a firm with a high market share may not possess durable market power because of the threat of losing its customers to new or existing rivals. Additional factors, discussed below, also should be considered.
52. Certain measures for concentration used in the mergers context, such as concentration ratios and the Herfindahl-Hirschman Index, are not generally used to assess dominance in unilateral conduct cases because the focus of assessing dominance is on a single firm's market power, rather than the overall degree of concentration in the market.

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<sup>32</sup> See Report, at 3.

<sup>33</sup> See Recommended Practices, RP 3 cmts. 1-2.

<sup>34</sup> Recommended Practices, RP 2 cmt. 2.

<sup>35</sup> Recommended Practices, RP 3 cmt. 2.

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### A. Calculating Market Shares in the Relevant Market

53. Market share calculations should be based on reliable data sources.<sup>36</sup> In addition, market shares should be calculated on the basis of a measure that is comparable across competitors within the relevant market.
54. Production and sales volumes, whether measured by physical or monetary unit, are the most widely used data to calculate market shares.<sup>37</sup> Calculating market shares using sales volume by monetary unit is often preferred when products are heterogeneous because the monetary unit serves as a common denominator. Market shares using sales volume by monetary unit also account for qualitative differences among heterogeneous products. By contrast, calculating market shares by sales of physical units is often preferred when output is measured in a standard unit such as tonnage. Particular industries also sometimes adopt specialized output measures that can serve as the basis for calculating market shares.
55. Other measures for calculating market shares, such as reserves or production capacity, can also be helpful in some instances. For example, in mining industries, a firm's reserves may best reflect its current and future competitive presence. Similarly, in a given market, it may be appropriate to determine market shares on the basis of production capacity.

### B. Interpreting Market Shares

56. A very high market share suggests that customers may have few alternatives from which to choose in the event that the firm increases price, and that competitors may be unable to

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<sup>36</sup> Recommended Practices, RP 4 cmt. 1.

<sup>37</sup> Merger Workbook, at B.6.

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frustrate efforts to restrict output or raise price. Conversely, a low market share suggests that any reductions in output rates or increases in price by the firm are likely to be constrained by other firms. Defection of a significant number of the firm's customers to a competing firm may be sufficient to make any attempt to increase prices unprofitable.

57. Agencies may wish to consider the distribution of market shares. For example, depending on the nature of the market, a firm with a high market share may be more able to exercise market power when it faces a number of small rivals, as opposed to a single larger competitor. In other circumstances, the presence of a single, larger rival may reduce the likelihood that a maverick competitor will challenge the allegedly dominant firm.
58. When assessing market share, it often may be helpful for an agency to consider market data over several past years.<sup>38</sup> Significant and frequent shifts in market shares may be indicative of healthy competition. In contrast, if a firm has consistently maintained or increased its market share over a substantial period of time, this tends to reinforce the inference of dominance from a high market share, for example by suggesting that entry is difficult. However, a consistently high market share may also be the result of a firm's ability to stay ahead of its rivals through constant innovation and development of products that appeal to customers.
59. Some markets are characterized by large and infrequent orders made by a small number of customers. In such markets, it is generally helpful to analyze market shares over at least several years. For example, municipalities may occasionally call for tenders on contracts for services to be provided over a number of years. The winning bidder may be

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<sup>38</sup> Report, at 46.

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the sole provider of these services for that municipality for the duration of the contract, but face pressure from its competing providers when the contract comes up for renewal.

60. The interpretation of market shares should also reflect expected or reasonably likely future changes in market conditions.<sup>39</sup> If rival firms are poised to exit (or enter) the market, the alleged dominant firm's share may understate (or overstate) the firm's market power. The same is true if existing firms other than the alleged dominant firm are in the process of adding or retiring capacity. Although it can be challenging, agencies may wish to project market shares several years into the future, especially if any significant changes have recently occurred in the competitive environment of the relevant market, such as technological changes, innovation, and changes in regulatory requirements.

### **C. Market-Share Based Presumptions and Safe Harbors**

61. In most jurisdictions, a high market share is one factor among several that must be present before dominance is found.<sup>40</sup> In some jurisdictions, market share thresholds can be used as a basis for establishing a presumption of dominance or a safe harbor.<sup>41</sup> Such presumptions and safe harbors have been defined through statutes, guidelines, and court decisions.<sup>42</sup>

#### **1. Market Share-Based Thresholds that Create a Presumption of Dominance**

62. In some jurisdictions, a sufficiently high market share may create a legal presumption of dominance.<sup>43</sup> Under a market share-based presumption, once a firm is shown to meet the

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<sup>39</sup> Recommended Practices, RP 4 cmt. 2.

<sup>40</sup> Recommended Practices, RP 6 cmt. 3.

<sup>41</sup> *See* Report, at 3 & n.6.

<sup>42</sup> *See* Report, at 47.

<sup>43</sup> *See* Recommended Practice, RP 6 cmt. 1.

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threshold market share, it shifts the burden to the defendant to bring forward evidence showing that it is not dominant.<sup>44</sup> However, even when a legal presumption is created by law or policy, the agency should remain receptive to evidence that may overcome the presumption, for example, evidence that entry is easy.<sup>45</sup>

63. Implementing a threshold and determining its level involves a weighing of the benefits against the risks. Use of presumptions may increase enforcement efficiency by limiting use of enforcement resources by shifting the burden of proof to firms.<sup>46</sup> However, a presumption may lead to findings of dominance where it is not warranted, leading to enforcement errors and misallocation of enforcement resources.<sup>47</sup>
64. Defining a market narrowly in order to increase the calculated market shares so that they exceed a presumption threshold increases the risk of enforcement errors.
65. In the absence of a presumption of dominance, high market shares still serve as an initial indicator of dominance. Nonetheless, the burden of carrying out an investigation and bringing forward evidence to establish dominance remains with the agency.<sup>48</sup>

### 2. Market Share-based Thresholds Used to Create Safe Harbors

66. A low market share could place a firm within a “safe harbor,” within which a firm is presumed not to be dominant.<sup>49</sup> For example, a safe harbor of 20% market share means that the agency will consider a firm with less than a 20% share not to be dominant.

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<sup>44</sup> Recommended Practices, RP 6 cmt. 1.

<sup>45</sup> Recommended Practices, RP 2 cmt. 2.

<sup>46</sup> Recommended Practices, RP 6 cmt. 2.

<sup>47</sup> *See* Recommended Practices, RP 6, cmt. 2.

<sup>48</sup> *See* Recommended Practices, RP 6, cmt. 1.

<sup>49</sup> *See* Recommended Practices, RP 5, cmt. 1.

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67. An agency may create a “hard” safe harbor, meaning that the agency will find that the firm is not dominant if its market share falls under the safe harbor level regardless of other market conditions.<sup>50</sup> Hard safe harbors have the advantage of increasing legal certainty for businesses. Such harbors also reduce agency enforcement burdens by removing the need for further investigation and analysis when market share levels are below the threshold. However, the agency may erroneously overlook situations of dominance when it would otherwise be found, particularly if the safe harbor is relatively high.
68. Alternatively, an agency may establish safe harbors that create a rebuttable presumption against a finding of dominance.<sup>51</sup> Presumptive safe harbors provide some legal guidance for businesses, as the agency indicates that dominance could be found only in exceptional circumstances.
69. Without sufficient care, both hard safe harbors and presumptive safe harbors may result in an over-emphasis on market shares at the expense of other factors in the market, which may lead to enforcement errors.<sup>52</sup> In the case of safe harbors with very low thresholds, the risk of an enforcement error is lessened, although the usefulness of the safe harbor is lessened as well.

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<sup>50</sup> Recommended Practices, RP 5 cmt. 2.

<sup>51</sup> Recommended Practices, RP 5 cmt. 2; Report, at 48.

<sup>52</sup> Recommended Practices, RP 5, cmt. 2.

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### IV. Expansion and Entry Analysis

70. In evaluating the existence of dominance, agencies should consider the likelihood that expansion by existing competitors or entry by potential competitors would defeat an exercise of market power.

Entry analysis provides information on the significance of potential competitors for competition in the market concerned and thus about market power and its durability, to the extent such power is found. Analysis of expansion provides information on the potential impact of expansion by competitors already active in the market.<sup>53</sup>

The relevant question is whether entry or expansion will “pose a credible competitive constraint on the incumbent.”<sup>54</sup> This question typically is posed in terms of the existence of barriers to entry or expansion, as explained in the ICN Recommended Practices:

If barriers to entry/expansion faced by actual or potential competitors are low, the fact that one firm has a high market share may not be indicative of durable market power. By contrast, substantial barriers to entry/expansion may imply the absence or limited importance of (potential) competitive constraints on the firm alleged to be dominant or in possession of substantial market power.<sup>55</sup>

71. To determine whether a firm’s market power is durable, therefore, agencies generally examine various barriers that affect whether entry or expansion is timely, likely, and sufficient to preclude the exercise of market power. Entry is likely to occur if it would be profitable.<sup>56</sup> If barriers would substantially delay entry or expansion, the impact may not

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<sup>53</sup> Recommended Practices, RP 7, cmt. 1.

<sup>54</sup> Recommended Practices, RP 7, cmt. 1.

<sup>55</sup> Recommended Practices, RP 7, cmt. 2.

<sup>56</sup> Recommended Practices, RP 7, cmt. 3.

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be sufficiently timely to affect the incumbent's conduct.<sup>57</sup> Expansion or entry must also be sufficient to defeat the exercise of market power, i.e., it "must be large enough, and of a character, to constrain the firm alleged to be dominant or in possession of substantial market power to a sufficient extent."<sup>58</sup> However, the mere presence of some barriers does not mean that they are sufficient to prevent entry that is timely, likely and sufficient. Accordingly, the analysis must comprehensively assess the likelihood of expansion or entry in light of "the cumulative impact of all barriers in a given market."<sup>59</sup>

### A. Assessing Potential Entry or Expansion

72. Barriers to entry or expansion can be divided into three categories: **structural**, **strategic**, and **regulatory**. Structural barriers are market characteristics. They result from supply factors such as sunk costs, economies of scale and scope, and scarce inputs, and from demand factors such as a firm's reputation.<sup>60</sup> Strategic barriers are created by the conduct of incumbent firms through such things as investment in excess capacity or supply and distribution contracts.<sup>61</sup> Finally, regulatory barriers result from rights protected by law, such as intellectual property rights, and from administrative regulations that could favor incumbents or even prohibit entry or expansion.

#### 1. Structural Barriers to Entry or Expansion

73. **Sunk costs** are outlays associated with investments necessary for entry or expansion that cannot be recovered by reversing the entry or expansion decision. These costs may act as

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<sup>57</sup> Recommended Practices, RP 7 cmt. 4.

<sup>58</sup> Recommended Practices, RP 7 cmt. 5.

<sup>59</sup> Recommended Practices, RP 7 cmt. 3.

<sup>60</sup> Recommended Practices, RP 7 cmt. 3.

<sup>61</sup> Recommended Practices, RP 7 cmt. 3.

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a barrier because they increase the risk that an investment in entry will not be profitable.

Sunk costs include not only some costs associated with building a manufacturing facility or purchasing equipment, but also costs associated with research and development, consumer research, start-up marketing, and product design. Costs that can be recovered by selling facilities or converting them to other uses are not sunk costs. For instance, if a manufacturing facility can be converted to another use, only the portion of the investment that would be lost is considered sunk cost.

74. **Economies of scale** refer to the reduction in long-run average costs that come from operation at a larger scale, i.e., at a greater level of output. Economies of scale are sometimes viewed as a barrier to entry because they make operation at small market share unattractive. In such circumstances, entry would have to be at a large scale, putting a large investment at risk and making success dependent on the ability to attract a substantial fraction of incumbents' customers, which in turn is likely to require pricing well below pre-entry levels.
75. The costs of entry or expansion may also be affected by **economies of scope**, which are the reduction in long-run average costs as a result of producing or distributing multiple distinct products. If economies of scope are significant, successful entry into one market could require entry in to several others as well, thereby increasing the investment necessary to enter or expand and requiring the entrant to confront additional obstacles.
76. **Network effects** occur when a good or service increases in value to potential customers as the number of existing customers increases. In the presence of network effects, the attractiveness of the good or service to a customer depends on the extent to which the associated platform (such as a gaming system, payment card scheme or ticketing service)

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is widely used and accepted. Network effects may act as a barrier to entry or expansion because an incumbent may have the advantage of significant network effects, which an entrant would lack unless it could displace the incumbent's network.

77. **Firm or product reputation** is often important for differentiated consumer products and may be important for certain industrial products. Consumers may value a firm's or product's reputation, and convincing consumers to switch to an entrant's products may require substantial marketing investment and a long time to develop a comparable reputation. Purchasers of certain industrial products also may value product reputation if testing new products is expensive and if failure is catastrophic.
78. **Scarce necessary inputs**, whether physical or technical (such as know-how), may also create barriers to entry or expansion. For instance, entry into production of a certain electronic devices may require access to patented technology or a component subject to a patent, and entry into production of a certain metal could require access to ore deposits. An entrant could be unable to secure access to such scarce inputs.
79. The foregoing types of barriers often work in combination. For example, a large, well-established incumbent may have made sunk investments in a highly developed sales network that takes advantage of economies of scale and scope.
80. In addition, the factors imply that **isolation or size of economy** may be an important entry consideration. All other things being equal, an economy that is relatively small and/or isolated is more likely to have firms that dominate markets within it. This is because smallness and isolation may limit the number of firms that can serve a market, due to lack of scale economies, and such factors may also suggest that the economy in question would be a less attractive target for entry. Thus, entry barriers may be higher for

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a small and/or isolated economy.<sup>62</sup> On the other hand, a small economy's openness to trade can be seen as making it less isolated and lowering entry barriers, and thus making the exercise of substantial market power less likely. The fact that an economy is small and/or isolated is alone not sufficient for a finding of barriers to entry, but may be one of several considerations potentially relevant to the dominance assessment.

### 2. Strategic Barriers to Entry or Expansion

81. Strategic barriers created by incumbent firm conduct may deter entry or expansion by competitors. Strategic conduct may make entry or expansion unprofitable, or such conduct may simply make entry more difficult. However, business decisions that create barriers to entry or expansion are not necessarily an abuse of dominance, and often are part of legitimate, procompetitive business behavior. In assessing potential barriers to entry or expansion, the question is only whether the barriers created by the conduct increase the costs or difficulty of entry or expansion, regardless of whether the conduct may also qualify as an abuse. Thus the test for whether conduct creates barriers to entry or expansion is different from the test for whether that conduct constitutes an abuse of dominance.
82. An incumbent with excess capacity may deter entry by threatening to increase output in response to entry or expansion, thereby lowering prices and making a competitor's entry or expansion unprofitable. Excess capacity may be held for legitimate reasons (e.g., potential increases in demand). As a result, the implications of excess capacity are assessed in light of the incumbent's past response to entry.

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<sup>62</sup> See Recommended Practices, RP 9.

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83. An incumbent's existing contracts may limit an entrant's or expanding firm's ability to obtain necessary supplies or to access necessary distribution. Especially in industries marked by significant economies of scale, an incumbent may "lock up" a sufficient portion of suppliers or distributors with long-term contracts to render entry infeasible or excessively costly. The assessment of an incumbent's existing contracts considers the contracts' duration, scope, the amount of the market covered, and termination provisions.
84. Vertical integration may give the incumbent firm advantages over rivals, and thus contribute to its dominant position. While there may be nothing inappropriate or questionable about such advantages, their existence can be relevant to the assessment of dominance.
85. A vertically integrated incumbent may have assured access to scarce inputs or distribution systems, which entrants would have difficulty obtaining. In the extreme, an incumbent may own the only source of an input. In either case, the incumbent could be able to block entry by denying access.
86. Another way that vertical integration may raise barriers to entry is that a competitor might be forced to enter two markets simultaneously in order to compete against the incumbent.<sup>63</sup> The requirement of simultaneous entry at two levels can deter entry by increasing sunk costs associated with entry and by increasing the efficient scale of entry.

### 3. Regulatory Barriers to Entry

87. Government regulation can be a source of entry or expansion barriers. Legal or administrative regulation may take the form of statutory monopolies or limits on the

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<sup>63</sup> See OECD Competition Policy Roundtables, *Barriers to Entry*, DAF/COMP(2005)42, § 3.2, at ¶ 10, available at <http://www.oecd.org/dataoecd/43/49/36344429.pdf>.

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number of firms, regulatory approval or licensing requirements, intellectual property rights, and others.

88. Government regulation often pursues public interest objectives (e.g., health and safety, environmental protection, urban planning) which may require limitations on market competition compatible with such goals. In these circumstances, regulation may prevent entry in an absolute or a significant manner.
89. Where a regulation sets objective standards, and these standards apply equally to all competitors, they generally do not affect the cost for new entrants more than they affect the cost for incumbents, and do not constitute barriers to entry or expansion under one commonly used definition of the term. However, the cost of complying with regulations may have economies of scale and may be a sunk cost, both of which can inhibit entry. In addition, regulation may not apply equally to all competitors (such as by exempting, or “grandfathering,” incumbents from new requirements), and regulatory standards resulting from incumbents’ lobbying of regulatory agencies or other government decisionmakers can disadvantage new entrants.
90. In certain sectors, licences may be restricted because of the finite resources available. Examples may be found in regulated markets such as telecommunications (limited number of radio frequencies existing on a given spectrum) and air transport (limits to the landing or gate slots available at a given airport at a given time). In these sectors, as in several others, selected firms may be granted exclusive concessions (in some cases, statutory monopolies) to provide the product or service in question, or enjoy by statute exclusive or preferential access to the essential facility necessary to carry out the regulated activity.

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91. Intellectual property rights (“IPRs”) may also amount to legal barriers when they prevent or make more difficult market entry or expansion by competitors. In principle, IPRs are indicative of a dominant position only when the product or technology protected by the IPRs corresponds to a relevant product or technology market, and accordingly, a legal monopoly on a given product or technology equates to an economic monopoly on a given market for the IPR owner. If the relevant product or technology market is wider than the IPR-protected market, it is unlikely that the IP owner holds a dominant position, although IPR ownership may confer an advantage.

### **B. Sources of Evidence Regarding Entry**

92. Agencies may be able to obtain information regarding the ease of entry or expansion from a number of sources, which may vary by industry. Incumbent firms often have relevant information because they likely deal with the barriers themselves or often recognize them in their business documents. Potential entrants often assess entry barriers in making business decisions.
93. Suppliers and customers may have relevant information, especially concerning an incumbent’s contracting arrangements. Investment analysts, industry consultants, and industry analysts often discuss barriers to entry or expansion in their analyses as well. This information may often be obtained through informal interviews as well as through formal processes.
94. Examination of recent entry or expansion (or the lack thereof) can be useful. A history of expansion or entry in the market can provide sound evidence that potential obstacles to

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expansion or entry are not decisive.<sup>64</sup> For historical evidence to be a reliable indicator of potential entry or expansion, however, the present market conditions must be similar to those existing during the historical period under consideration. It is therefore necessary to confirm that the characteristics of the industry have not changed substantially, that prior entry or expansion has not resulted in substantial excess capacity that could make further entry more risky, that sufficient supply of necessary inputs is currently available, and other important industry conditions have remained stable and do not affect the likelihood of entry.

95. In addition, where there has been recent entry or expansion, agencies should confirm that it has in fact constrained the incumbent. For example, evidence that the entry or expansion (1) took significant sales away from the incumbent (and not just other small competitors), (2) that entry or expansion occurred relatively quickly, (3) that entry or expansion was sustained over a substantial period of time, and (4) that the entrant or firm that expanded was not unique in some way, all may be reasons for an agency to credit the evidence of recent entry as being relevant to the likelihood of further entry. Prior entry into market niches, by comparison, may not have imposed significant constraints on the incumbent.
96. A lack of successful recent entry or expansion may suggest that entry or expansion is unlikely. However, the lack of entry or expansion may have occurred because prices were already at the competitive level or may reflect conditions that no longer exist. Accordingly, it is important to exercise caution in reaching conclusions based on the lack of entry. It can be especially useful to evaluate unsuccessful attempts to enter or expand

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<sup>64</sup> Merger Workbook, at E.10.

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to determine the cause of failure. Failure due to identifiable barriers to entry can establish their significance. But failure may also be caused by factors such as poor management, poor planning, or inadequate financing on the part of the entrant.

### C. Conclusions

97. In assessing evidence regarding entry, agencies seek to determine whether entry or expansion is likely to occur on sufficient scale and within a given time period to defeat supracompetitive pricing.<sup>65</sup> Generally, no single set of evidence is dispositive on this question. Typically, the conclusion relies upon a combination of evidence as well as the assistance of economic or accounting experts.

## V. **The Effect of Buyer Power on the Assessment of Dominance**

98. The existence and durability of dominance of a supplier may be affected not only by the number and strength of its competitors, but may also be influenced by the structure and characteristics of the opposite market side, in particular by the countervailing buyer power of customers. Such power stems from the bargaining strength that the buyer has vis-à-vis the seller.<sup>66</sup>
99. “Buyer power” is market power on the buyer side of a market. It has also been defined as “the ability of buyer to influence the terms and conditions on which it purchases goods.”<sup>67</sup> In some circumstances, powerful customers may have the incentive and ability

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<sup>65</sup> Recommended Practices, RP 7 cmt. 3.

<sup>66</sup> See Recommended Practices, RP 2 cmt. 2 & RP 8 cmt.

<sup>67</sup> See OECD, Directorate for Financial, Fiscal and Enterprise Affairs Committee on Competition Law and Policy, *Buying Power of Multiproduct Retailer*, DAFPE/CLP(99)21 (1998), Background Paper, at 18, available at: <http://www.oecd.org/dataoecd/1/18/2379299.pdf>.

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to defeat the exercise of market power.<sup>68</sup> Even the most powerful buyer, however, in general has a disciplinary effect on a supplier only if there is a credible threat that it could switch to another supplier to a sufficient extent.

100. The conclusion that no dominance exists based exclusively on countervailing buyer power is likely to be correct only if the buyer has power of a sufficient magnitude to defeat an exercise of market power by the allegedly dominant firm. Furthermore, such power is not an effective constraint if it ensures that only a limited segment of consumers would be protected. The bargaining strength of the buyer may depend on several factors: the (absolute and/or relative) size of the buyer (as compared to the seller), its commercial significance to the seller and, critically, its ability to switch to alternative suppliers.
101. Any alternative sources of supply, in particular vertical integration of the buyer or a possibility of (induced) entry into the incumbent's market, must be timely and likely in order for them to be considered as a sufficiently plausible source of buyer strength.

### **A. Factors to Be Considered in Assessing Buyer Power**

102. The following factors may be relevant in the context of analysing the existence and degree of countervailing buyer power, many of which are also covered in, for example, assessing barriers to entry and expansion.
103. The ability of the buyer to **credibly threaten to resort**, within a reasonable time frame, **to alternative sources of supply**, and hence to refuse to buy products from the seller. Such sources may be actual or potential competitors of the supplier, but in some instances, the customer may even encourage and assist market entry by new competitors.

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<sup>68</sup> See Report, at 55.

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Another way for the buyer to defeat the exercise of market power by a seller is to integrate vertically and to acquire a manufacturer, or to establish new production facilities for future in-house supply. A prerequisite for successfully exercising buyer power is that the buyer is well informed about alternative supply.

104. In general, the credibility of a threat to use an alternative source of supply is closely connected to the **switching cost** the buyer would have to incur. High switching cost may make it unprofitable for the buyer to change its supplier and, therefore, undermine any threat to resort to alternative sources of supply.
105. It is important to assess the product's commercial significance to the buyer. If the buyer is dependent on the delivery of the product on a short-term or steady basis, it will not be feasible to exert much pressure on the seller.
106. **The buyer's significance to the seller.** If the buyer accounts for a significant share of the seller's output, and the seller has poor alternatives, then the buyer's refusal to purchase may allow it to discipline possible exercises of dominance. A case of particular importance is when the buyer is a gateway to a downstream market.
107. The **expertise and special know-how** of the buyer with regard to the supplied product, its comprehensive knowledge about the market concerned, and/or its ability to make use of special characteristics of the relevant market.
108. **Buying habits and procedures.** In circumstances in which buyers choose their suppliers through procurement auctions or tenders, competition may be intense even though only a few suppliers exist and participate in the bidding or auction process.<sup>69</sup>

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<sup>69</sup> Merger Workbook, at C.12; *see also* Report, at 55.

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109. **Market-specific aspects** (such as the presence of network effects) may limit or enhance the significance of buyer power. When access to the buyer's network is crucial, the supplier's dependency on the buyer may allow the latter to dictate the terms of supply.

### **B. Limitations on the Effects of Countervailing Buyer Power**

110. If only certain customers (or categories of customers) have buyer power, then that power is not likely to effectively counter the exercise of dominance by a seller.<sup>70</sup> Only if the smaller/weaker customers benefit indirectly (or directly) from the competitive constraints on the seller due to the existence of countervailing buyer power will the buyer power sufficiently prevent the exercise of dominance.
111. Similarly, the countervailing strength of the buyer, e.g., a big supermarket group or retail chain, may, however, be neutralised by the strength of manufacturers' brands, which can be so important that a retailer must display them on its shelves (so-called "must stock" items).
112. In addition, buyer power should not only exist in a certain special situation, or for a very limited period of time, but must remain effective for the reasonably foreseeable future in order to justify the conclusion that the supplier—despite other indicators of dominance such as high market shares—will not be able to exercise dominance in a way that would produce considerable negative effects on competition.
113. Even if the prerequisites for exercising sufficient competitive pressure on a possibly strong seller by buyers are fulfilled, not all competitive concerns may be eliminated. Countervailing buyer power may lead to negotiation failures, enhanced coordination by

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<sup>70</sup> See Merger Workbook, at C.12.

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the buyers in other markets, discrimination issues, or to the reduction of incentives for innovation and investment upstream to the detriment of consumers. These limitations of the concept should also be kept in mind when assessing the effects of countervailing buyer power.