CRA Conference – Panel on rebates

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Competitive effects of rebates: Seeking economic and legal consistency

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*The views expressed are those of the speaker and do not necessarily reflect those of DG Competition or the European Commission

A *naïve* form-based approach?

- The [anti-competitive] effect referred to in the case law . . . does not necessarily relate to the actual effect of the abusive conduct complained of. For the purposes of establishing an infringement of Article 102 EC, it is sufficient to show that the abusive conduct of the undertaking in a dominant position tends to restrict competition or, in other words, that the conduct is capable of having that effect"

(Michelin II, p. 239)

- Many commentators argue that since "capability to foreclose" is (or derives from) a feature or characteristic of the practice, this implies that the Court endorses a form-based analysis

A *naïve* form-based approach?

- Arguably such “form-based” approach was again (and most recently) adopted by the General Court in its Tomra decision. It has been argued:
  - the Commission focused only on the form of the rebates and presumed the existence of anticompetitive effects. The Court followed.
  - Allegedly, there are no attempts at evaluating whether Tomra's rebates actually harmed competition or consumers

Rebates have been classified according to a number of formal (or descriptive) criteria

- A discount applies after meeting a given sales threshold
  - may apply either to all purchased units (so-called *retroactive rebates*),
  - or may apply only to those units that exceed the threshold (so-called *incremental rebates*).
- Targeting:
  - Rebates can be targeted at individual demands (so-called *individualized rebates*)
  - The same scheme applies to all customers (so-called *generalized rebates*)
- The nature of the threshold (beyond which a rebate is granted)
  - may be a quantity threshold (so-called *volume discounts*)
  - or the customer may have to source a certain percentage of his requirements from the producer (so-called market-share contracts).

"Evidence" in support of the claim the Court endorses a *naïve* form-based approach?

- Retroactive rebates have generally been found abusive in a number of cases.
- Individualised rebates have been considered as more likely harmful (see Hoffman-La Roche).
  - But even generalised rebates, if retroactive can be considered abusive (see Michelin II).
- Finally, market share contracts have been prohibited among others in Hoffman-La Roche, Michelin II and Intel.

- The only types of rebates the Court has considered not to produce anticompetitive foreclosure effects are therefore incremental, generalized, volume discounts.
  - However, even those rebates are acceptable only if they reflect cost savings or other efficiency gains in distribution (see Michelin II and BA/Virgin)

Analysis of form vs. analysis of effects

- A *naïve* form-based analysis presumes that a certain practice is abusive if the description of its key elements matches one or more of a predetermined list of characteristics.
  - Corollary 1: there is no need to assess whether the practice "is capable of" or "is likely to" have exclusionary effects, let alone whether it actually had any such effects.
  - Corollary 2: to avoid an infringement a dominant firm must simply take care that a description of the practice does not obviously match that of the predetermined list
- Twin problems: legal uncertainty, weak enforcement

Neither the Commission nor the Courts are naïve. Concerns is with "effects", not with "form"

- Court of Justice defined exclusionary abuses in Hoffman-La Roche.
- This definition was slightly refined in Michelin v Commission (322/81), 9 November 1983, par 70:
  - "As regards the application of Article 86 to a system of discounts conditional upon the attainment of sales targets, such as described above, it must be stated first of all that in prohibiting any abuse of a dominant position on the market in so far as it may affect trade between Member States Article 86 covers practices which are likely to affect the structure of a market where, as a direct result of the presence of the undertaking in question, competition has already been weakened and which, through recourse to methods different from those governing normal competition in products or services based on traders' performance, have the effect of hindering the maintenance or development of the level of competition still existing on the market."

Legal definition of abuse: Further clarification

- Case C-95/04 P British Airways v. Commission [2007] ECR I-2331, par 106:
  - "Article [102 TFEU] is not only aimed at practices which may cause prejudice to consumers directly, but also at those which are detrimental to them through their impact on an effective competition structure [...] The Court of First Instance was therefore entitled, without committing any error of law, not to examine whether BA's conduct had caused prejudice to consumers [...] but to examine [...] whether the bonus schemes at issue had a restrictive effect on competition."

The Commission, investigated to some extent the likely effects of Tomra’s practices on the market

- That Tomra’s exclusionary strategy did have the intended effects was demonstrated by several developments on the market as, for instance, the evolution of Tomra’s market position. The market shares of Tomra have remained rather stable, compared to the weak market position of its rivals.
  - Its market share always remained very high in all individual markets and in the EEA in general, especially considering the characteristics of the RVM market where demand is essentially nonrecurring and generally cannot be expected to remain stable over the course of several years.
- There were periodic positive demand shocks on most of the markets due to the introduction of mandatory deposit systems
  - However, there was actually, no successful entry into any of the relevant national markets during the time frame covered by the decision.
  - On the contrary, some of the competitors left the market due to either insolvency or acquisition.
- the Commission also observed that Tomra would sell a higher number of machines during the years where more of the total market demand was covered by its exclusionary agreements.
  - On the contrary, when less demand on the market was covered by Tomra’s anti-competitive arrangements, Tomra’s market share would decrease.

The ECJ Judgement in Deutsche Telekom

- 253 As is already apparent from paragraphs 177 and 178 of the present judgment, a pricing practice such as that at issue in the judgment under appeal that is adopted by a dominant undertaking such as the appellant **constitutes an abuse** within the meaning of Article 82 EC **if it has an exclusionary effect** on competitors **who are at least as efficient** as the dominant undertaking itself by squeezing their margins **and is capable of making market entry more difficult** or impossible for those competitors, **and thus of strengthening its dominant position** on that market **to the detriment of consumers' interests.**

- **Admittedly**, where a dominant undertaking actually implements a pricing practice resulting in a margin squeeze of its equally efficient competitors, with the purpose of driving them from the relevant market, **the fact that the desired result is not ultimately achieved does not alter its categorisation as abuse within the meaning of Article 82 EC**. However, **in the absence of any effect on the competitive situation of competitors, a pricing practice such as that at issue cannot be classified as exclusionary if it does not make their market penetration any more difficult**.

An effects-based analysis does necessarily imply in all circumstances proof of actual effects

- An effects-based analysis rather means that the standard of proof required to establish an infringement depends on the likelihood and significance of the effects on competition and ultimately consumers of a given practice:
  - According to the 102 Guidance Paper (par 17): "If it appears that the conduct can only raise obstacles to competition and that it creates no efficiencies, its anti-competitive effect may be inferred." (e.g. paying rivals to stay out of the market, paying customers not to test or to delay the introduction of rival products.
    - Such practices are rightly presumed illegal, similarly to price-fixing
  - Conduct that generally tends to restrict competition or, is "capable of having that effect" does not necessarily require proof of the actual effect. However it is necessary to show "capability to foreclose".
    - Such conduct can be considered a restriction of competition by object
  - For conduct which does not generally have "*the effect of hindering the maintenance or development of the level of competition still existing on the market.*", it would be necessary to show that in the circumstances of a given case, the conduct has actually led to anti-competitive foreclosure.
    - Such conduct can be considered as a restriction of competition by effect.

An effects-based analysis does necessarily imply in all circumstances proof of actual effects

- Note that according to the 102 Guidance Paper, in the latter two situations “dominant firms may justify the practice either by demonstrating that its conduct is objectively necessary or by demonstrating that its conduct produces substantial efficiencies which outweigh any anti-competitive effects on consumers”.

- Importantly, “the Commission will normally intervene under Article 82 where, on the basis of cogent and convincing evidence, the allegedly abusive conduct is likely to lead to anti-competitive foreclosure”:
  - "anti-competitive foreclosure“ refers to a situation where effective access of actual or potential competitors to supplies or markets is hampered or eliminated as a result of the conduct of the dominant firm to the detriment of consumers. The identification of likely consumer harm can rely on qualitative and, where possible and appropriate, quantitative evidence”

Competitive effects of rebates and discounts

- Diverse and sometimes significant pro-competitive effects:
  - (inter-alia) elimination of double marginalization, the efficient recovery of fixed costs, the stimulation of dealers' sales efforts, and the prevention of free-riding
- In itself the presence of efficiencies suggests:
  - that rebates cannot generally be presumed illegal (in the meaning of par 17 of the Guidance Paper)
  - that whether a the rebates leads to a restriction by object or effect, efficiencies can be advanced by the dominant firm and may outweigh the likely (or actual) anticompetitive effects

- But as emphasised by Hans Zenger et al (mimeo) the more essential legal question is prior to any such balancing. That is:

  - Do loyalty rebates (or at least certain forms of loyalty rebates) have an inherent anticompetitive character or tendency?
  - (and, hence, what should be the required evidentiary standard to establish an abuse?)

In general, loyalty rebates are not capable of restricting competition to the detriment of consumers (Hans Zenger et al, mimeo)…

- the use of all kinds of loyalty rebates is the natural outcome of the competitive process
  - it is not surprising that retroactive rebates, individualized rebates and market share contracts are naturally employed by competitive firms across all sectors of the economy

- Loyalty rebates allow innovators who have created an improved product or a more efficient production technology to earn a higher reward for their creative efforts.

- But they also induce a particularly fierce form of competition between the incumbent and rivals, once competing manufacturers have entered the market.
  - In other words, the use of loyalty rebates allows firms to decrease prices where the competitive pressure is intense, for the contestable requirements, or the contestable customers.

(Hans Zenger et al, mimeo)…

- Consumers therefore benefit from the existence of loyalty rebates both through the creation of better products and, ultimately, through lower prices.

- This is a more important reasons as to why blanket (or per-se) prohibitions (in the meaning of par 17 of the Guidance paper) to use loyalty rebates would add a significant additional inefficiency:
  - if rebates are not feasible this hampers firms' general incentives to compete, because inframarginal rents can only be protected from competition by setting generally higher prices.
  - This effect not only increases the price of the marginal units of a product, but may be so strong that the prices of *all units* increase as a result of the prohibition of loyalty rebates, including the price of all inframarginal units.

- In sum: discounts and rebates are a natural and integral part of the competitive process - no more or less "normal" than firms' general desire to lower prices in the face of competitive pressures

(Hans Zenger et al, mimeo)…

- The Court seems to recognize the importance of the free determination of prices in its application of Article 102(a) TFEU (the legal provision dealing with exploitative pricing).
- As Judge Nils Wahl of the General Court has noted, the Court has not yet condemned a particular pricing practice, in a free and unregulated market, as amounting to unfairly high and exploitative prices and thus constituting an infringement of Article [102]
- […] *Assuming that the primary objective of the pricing strategy of any firm (on a free market) is to extract the maximum from its customers, it is respectfully submitted that I fail to see that any price would be excessive in itself. Given what has been stated previously, it would seem as the prohibition against excessively high exploitative prices has its primary scope of application in situation of legal monopolies or regulated markets".*

However, economic analysis indicates that loyalty rebates can lead to anticompetitive foreclosure, [depending on the circumstances such restriction of competition may be object or by effect]

- Stylised Chicago argument:
  - A rational buyer would not be willing to accept a contract which obliges her to buy from an inefficient incumbent if a more efficient competitor is willing to enter the industry
  - Chicago School economists emphasised the efficiency effects of exclusive dealing contracts and played down the risk of foreclosure

- Rebuttal of Chicago argument: Rasmusen et al. (1991) and Segal and Whinston (1996, 2000) among others
  - Assume the entrant needs to supply a minimum number of buyers to cover its fixed costs.
  - A buyer's decision to accept an exclusive deal from the incumbent imposes an externality on the other buyers.
  - By exploiting this externality among (uncoordinated) buyers, the incumbent is able to deter entry.

loyalty rebates may lead to anticompetitive foreclosure

- Intuition
  - Why do buyers sign these contracts since they end up with having the incumbent as the only seller in the industry and pay a higher price for the good than if entry occurred?
    - If all the buyers sign the exclusive contract, no one has incentive to deviate.
    - By refusing to sign, a single buyer would not trigger entry and would have to buy the good from the incumbent anyway, at a higher price.
    - The deviation is not profitable and all the buyers signing the exclusive contract can be an equilibrium.
- Due to customer asymmetries some may generally prefer to purchase from the incumbent. The greater the share of customers that have a strict preference for the incumbent…
  - the greater the chances that insufficient buyers will sign with the new entrant and
  - the more likely that naked exclusion can be sustained by preventing competing rivals from reaching sufficient scale or benefitting from network or reputation effects and thereby deterring entry, expansion or innovation and new product development.

Exclusivity and downstream competition

- Exclusive contract is anticompetitive because it may deter efficient entry and thereby reduce welfare.
- If buyers are competing firms and they compete intensively, then an exclusive contract can deter efficient entry because exclusive dealing increases the joint surplus between contracting parties by extracting surplus from final consumers. Simpson and Wickelgren (2007) and Abito and Wright (2008)
- Upstream: Incumbent manufacturer, more efficient potential entrant.

  Downstream: Two retailers competing for final consumers

Stage 1:	Exclusive contract by I who offers fixed compensation
Stage 2:	Entry (E) decision after observing retailers' decisions
Stage 3:	I and E (if entered) make offers to each available retailer
Stage 4:	Retailers compete by setting prices

- Assume intense competition downstream
  - Downstream firms have little rents
  - An upstream monopolist can extract all rents (no double marginalisation)
  - In case of upstream entry, rents downstream will remain small
  - So, the upstream incumbent (who moves first) can easily “bribe” the downstream into an exclusive contract (at the expense of the final consumers)
  - Whatever the fixed cost of entry, exclusion is the only equilibrium
- Assume some differentiation downstream
  - An upstream monopolist has lower rents and downstream firms are harder to “bribe”
  - But the entrant may face a coordination problem (he may need to attract both downstream firms) if fixed costs are high
  - Then if downstream competition is weak enough, there is both an exclusion and an entry equilibrium.
    - And when wholesale pricing is allowed to be non-linear exclusion is the only equilibrium regardless of the degree of downstream competition

The Guidance paper reflects current economic thinking

- The guidance paper emphasizes the potential anti-competitive effects of rebates as mechanisms to induce exclusivity
- Conditional retroactive rebates essentially provide a bribe for the buyer to source a certain share of its requirements (partial exclusivity) from the same seller.

- It is useful to emphasize two relevant sets of circumstances
  - The dominant firm has some special characteristics such that the entry cannot challenge its entire sales. There is a non-contestable part of demand (Greenlee et al 2005, 2007)
  - Buyers downstream compete : downstream firms may be willing to sign exclusive contracts such that competition is restricted or entry prevented (e.g. Abito & Wright, 2008)

The Guidance paper reflects current economic thinking…

- "As with exclusive purchasing obligations, the likelihood of anticompetitive foreclosure is higher where competitors are not able to compete on equal terms for the entire demand of each individual customer"

- The dominant firm has some special characteristics such that the entry cannot challenge its entire sales allowing and thus finance the rebate without making a loss:

  "A conditional rebate granted by a dominant undertaking may enable it to use the 'non contestable' portion of the demand of each customer (i.e. the amount that would anyhow be purchased by the customer from the dominant undertaking) as leverage to decrease the price to be paid for the 'contestable' portion of demand (i.e. the amount for which the customer may prefer and be able to find substitutes).

Example: Assessment in Intel

- (par 925) […] the Commission will in addition demonstrate in sections 4.2.3-4.2.6 that, on top of fulfilling the conditions of the case law […] the conditional rebates that Intel granted to Dell, HP, NEC and Lenovo and the conditional payments granted to MSH were capable of causing or likely to cause **anticompetitive foreclosure** (which is likely to result in **consumer harm**).
- […]**one possible way** of showing whether Intel's rebates and payments were capable of causing or likely to cause anticompetitive foreclosure is to conduct an as efficient competitor analysis (section 4.2.3).

- On the basis of the results of:

  – this analysis [i.e. as efficient competitor test] **and**
  – the **qualitative and quantitative evidence** (sections 4.2.4 and 4.2.5), **and**
  – given the **lack of objective justification and efficiencies** (section 4.2.6),

… the Commission concludes that Intel's conditional rebates to Dell, HP, NEC and Lenovo, as well as Intel's conditional payments to MSH, were an abuse under Article 82 of the Treaty

Intel rebates and exclusivity
(what does "loyalty-inducing" means in this context?)

- (938) This characterisation of the mechanism of the Intel discounts to Dell is misleading. Conditional rebates incite customers to stay loyal to the dominant firm **because they offer economically attractive conditions which can be obtained only if the customer achieves certain exclusivity conditions**. In those circumstances, **customers** which, on the basis only of competition on the merits, may have awarded a part of their purchases to a competing supplier, **may prefer to source all or nearly all of their inputs from the dominant company** in order to obtain the benefit of the discount.

- (939) This **economic inducement mechanism** functions irrespective of whether the benefits to the customer of staying exclusive are retrospective or prospective, and irrespective of whether they are guaranteed by contract or tacitly agreed. The mechanism works as soon as there is a sufficiently clear understanding for the customer that **the dominant company will award it certain rebates if it remains exclusive**, and **will not award them if it buys from competition**.

Was AMD partially excluded?

- For example, AMD was not in a position to offer a compensating rebate of the size required by HP.
- However, in order to seek to accommodate HP's concern, AMD offered HP one million x86 CPUs for free
- [AMD Executive], specified to HP: "*Agreement to these terms, as you must know, would require AMD to pay HPQ* [HP] *tens of millions of dollars to use its processors during the first year of this partnership. No reasonable business could offer these financial terms. The best we can do is to <u>offer you the processors for free</u>, which <u>no reasonable business partner could refuse to accept</u>.*"
- (957) However, HP ended up taking only 160 000 of the processors for free.
  - HP submitted to the Commission that this was a consequence of HP not wishing to lose the conditional rebate given by Intel : "[HP] *can confirm that Intel's inducements (in particular the block rebates) were a material factor in determining HP's agreement to the unwritten conditions.*

Why did OEMs take the “bribe”?
(effects on downstream competition matter)

- “Dell clearly perceived that any loss of rebate from Intel would also be complemented by increased rebates from Intel to Dell's OEM competitors (see recitals (235)-(237)).
- “Due to the strong presence of Intel on the market, **a substantial proportion of the competitive tenders in which HP participates is against competing OEMs which offer Intel-based desktops (such as Dell).** To the extent that one of those competitors obtains financial advantages from Intel for this, **any switch to AMD by HP would not only entail a loss in the HP rebate, but could also mean an increased rebate from Intel to the competitor**. This exacerbates the foreclosure impact.
- Among the many conditions that HP requested in order to accept an agreement with AMD were that "*AMD will establish a fund of $25M per quarter for the first three quarters of the agreement which HP can draw from as compensation for potential 'retaliatory‘ acts from Intel. Such acts may include unusual discounts that Intel may provide to an HP competitor targeted at impacting HPQ's PC business or the unusual loss of discounts or market development funds from Intel as a result of the execution of this agreement”.*

Why would AMD not reach a sufficient level of market sales to continue to exert a competitive constraint on Intel?

- "Certain OEMs, and in particular Dell and HP, are strategically more important than other OEMs in their ability to provide a x86 CPU manufacturer access to the market". The targetted OEMs have
  - a higher market share (section 4.2.4.1)
  - a strong presence in the more profitable part of the market (section 4.2.4.2);
  - ability to legitimise a new x86 CPU in the market (section 4.2.4.3).

What are the consequences if AMD is not able to exert a sufficient competitive constraint on Intel?

- Reduction in competitive pressure both upstream and consequently downstream and thus higher prices than in the absence of the conduct which would have allowed AMD to compete on the merits
- Reduction of consumer choice:
  - "In this regard, the magnitude of the consumer harm associated with such a loss of choice can be dependent on the remaining availability of close substitutes in the market
  - […] there are strong indications that Intel's practices with respect to the OEMs in question in themselves prevented **important and genuinely different** AMD-based products from ever being brought to the market in significant quantities.

Longer term impact due to the weakening of Intel's main competitor

- Financial constraints: “ The emergence of AMD as a competitive threat to Intel was dependent on **the availability of investors willing to finance risky investments in research and development** as well as AMD production facilities.
  - Such investments are only undertaken when there is a prospect of an adequate return if the research and development is successful and well implemented.

- Is there any evidence that innovation is NOT an important driver of competition in this industry?