



## Bulletin

Water

Energy

Retailing

Transport

Financial services

Healthcare

Telecoms

Media

Post

→ **Competition Policy**

Policy analysis and design

Regulation

Strategy

Contract design and evaluation

Dispute support services

Market design and auctions

**SEPTEMBER 2007**

## The price of loyalty

**APPLYING THE EUROPEAN COMMISSION'S PROPOSED APPROACH TO ASSESSING CONDITIONAL REBATE SCHEMES**

*The legality of conditional rebate schemes, when operated by dominant companies, has long been a controversial issue in European competition policy. These schemes involve discounts or rebates granted by suppliers to customers who commit to meet certain targets in their purchasing. This bulletin explores the implications of the proposed new effects-based regime for companies trying to assess the legality of their rebate schemes.*

Traditionally, the European Commission and Courts have considered conditional rebate schemes to constitute an abuse of market dominance under Article 82 of the EC Treaty, if they are of a form that can be expected to have a loyalty-inducing effect. This will typically have been presumed if a scheme involves rebates being granted retroactively on all of a customer's purchases, and not simply on incremental purchases above a target threshold. However, the Commission's discussion paper of December 2005<sup>1</sup> has signalled an intention to move to a more effects-based approach. That is to say, there is an intention to



make greater use of economic analysis in order to determine the impact of such schemes.

The Commission has proposed both a general framework for deciding when strategies employed by dominant firms might be deemed an abuse, and a number of specific foreclosure tests. Whilst many commentators have been broadly supportive of this so-called reform of Article 82, it remains a contentious issue. In question is the consistency with the jurisprudence of the European Courts (confirmed by the European Court of Justice's dismissal of British Airways' appeal against the judgment of the Court of First Instance, which had upheld a Commission decision prohibiting BA's travel agency incentive schemes<sup>2</sup>). Questioned too are the appropriate framework for the analysis and the suitability of the foreclosure tests proposed.

The discussion paper emphasises that it “cannot create any legitimate interest nor can it be relied upon to provide guidance to current Commission enforcement policy”. Nevertheless, various companies operating across Europe have sought to self-assess their rebating practices according to the proposed approach. This bulletin explores a number of important implementation issues that companies will need to consider with respect to retroactive schemes.

#### THE COMMISSION'S PROPOSED FRAMEWORK

The Commission's underlying concern is to prevent behaviour by a dominant company that leads to a weakening of the future competitive constraints. This will be presumed where efficient competitors are foreclosed from the market, whether deterred from entering, forced to exit, or prevented from expanding. The Commission makes it clear that rivals need not be forced out of the market altogether for conduct by a dominant firm to be deemed to have foreclosure effects. It is sufficient that an efficient competitor be partially denied profitable access to a market – that is to say, be unable to make profitable sales on a scale in line with its “commercially viable share”. This is defined as “the share of customers' requirements an efficient entrant can reasonably be expected to capture”. However, it is not sufficient for rivals to be foreclosed from profitably making sales to certain customers; the Commission is concerned with ensuring that competition is not eliminated from a “substantial part of the market”.

The specific concern with conditional rebate schemes is that they may disincentivise customers from splitting their purchases between the dominant firm and rival suppliers. This may happen if: (i) rivals are unable to contest the whole, or a significant proportion, of a customer's account, because the dominant firm has an element of “assured” sales; and (ii) the dominant firm creates a financial tie between the “assured” and the “contestable” elements of its sales, by providing financial rewards to those customers that purchase from it all, or a significant proportion, of their requirements. In particular, it is a common feature of retroactive rebate schemes that there may be a proportion of sales (close to the target threshold for purchases) where rivals might need to offer a price below cost in order to compensate the customer for the loss of the dominant firm's rebate if they are to secure these sales.

**BOX 1: A SIMPLE EXAMPLE – GIVING REBATES FOR EXCLUSIVITY**

Let's assume that:

- A customer has total requirements for 1m units of Wizznuts a year.
- The dominant supplier of Wizznuts has a list price of £1 per unit, but offers a rebate of 5% on all its purchases – provided the customer takes 100% of its requirements from this supplier – reducing its average price to 95p.
- A rival wishes to compete for part of this account. This supplier might be capable of selling 200,000 Wizznuts in the absence of the dominant supplier's rebate scheme – i.e., its “commercially viable share” of the account is 20%.

If this rival simply matches the dominant firm's average price of 95p per unit, the customer would be worse off purchasing 200,000 Wizznuts from this supplier, since the price of the remaining 800,000 needed would rise to £1. To offset the loss of the £50,000 rebate offered by the dominant supplier, its rival would need to offer an “effective price” as low as 75p. The arithmetic is as follows:

- Wizznuts bought from dominant supplier = 800,000 at £1 each = £800,000;
- Wizznuts bought from rival = 200,000 at 75p each = £150,000; so
- total cost = £800,000 plus £150,000 = £950,000.

In short, the dominant supplier is offering an “effective price” of 75p per Wizznut for the extra 20% sales that its rival can contest – that is to say, this is the price that the rival needs to match. The issue is whether an “as efficient” competitor could profitably supply the customer at this price. The Commission's proposed approach is to use the benchmark of the “average total cost” (ATC) of the dominant supplier to judge this. This means that the rival will only be presumed to be foreclosed if the dominant supplier's ATC is above 75p per Wizznut.

The Commission has indicated that rivals may be presumed to be foreclosed if the dominant firm sets its target threshold for a rebate above the level that would otherwise be purchased from it, and if rivals cannot profitably match the “effective price” charged by the dominant firm, including the effect of the discount scheme, for the marginal business that rivals would otherwise be able to contest. Box 1 demonstrates the proposed approach, which is to measure the “effective price” that the rival would need to offer, given its “commercially viable share”, in order to match the price of the dominant firm, and then to compare this effective price against the “average total cost” (ATC) of supply.

An alternative – and equivalent – approach would be to measure the “required share” that the rival would need to achieve in order both to match the dominant firm's offer and cover costs, namely, in the Commission's words, “the share of customers' requirements an entrant would need to capture so that the effective price resulting from the rebate would equal the average total cost of the dominant company”. The next step would be to compare this required share with the commercially viable share. The Commission has suggested that “where the required share exceeds the commercially viable share the rebate scheme is likely to have a foreclosure effect which reduces competition”.

Either way, the Commission's proposed framework depends on three elements: the nature of the rebate scheme; the average total cost of supply; and the volume of sales that rivals can reasonably be expected to contest. Below we discuss some important implementation issues in relation to each of these elements.

### IS THE TARGET THRESHOLD EFFECTIVE?

An effects-based analysis will typically begin by assessing whether the conditional rebate scheme in question is likely to provide the customer with an incentive to make additional purchases from the dominant firm that it would not otherwise make. A rebate scheme will not bite if the customer's purchases would exceed the dominant firm's target threshold in any event (for example, because the customer's own sales are growing). Nor will a rebate scheme bite if the customer would not find it profitable to buy enough to reach the threshold of the rebate scheme (for example, because the customer's own sales are falling).

The Commission's discussion paper recognises the importance of the way in which the target threshold is set:

In case the threshold(s) is (are) formulated in terms of a percentage of total requirements of the buyer or an individualised volume target, the Commission will normally presume that it (they) is (are) set at such level(s) as to hinder customers to switch to and purchase substantial additional amounts from other suppliers and thus enhance loyalty.

In case the threshold set is a standardised volume threshold, it is less likely that the rebate system will have a loyalty enhancing effect. Because the volume threshold at which the rebate kicks in is set at the same level for all buyers, the threshold may be too high for smaller buyers and/or too low for large buyers to have a loyalty-enhancing effect.

The extent to which customers will increase purchases in response to such schemes may be limited both by extraneous factors, such as the competitive conditions they face, and by constraints on their commercial strategies (for example, limits on the shelf space that could be provided by a retailer to the dominant firm, if final consumers demand a variety of alternative products). Any analysis must take these factors into account.

### MEASURING THE AVERAGE TOTAL COST OF SUPPLY

At the heart of the Commission's proposed framework is the concept of the "as efficient" competitor test. This is based on the premise that:

...in general only conduct which would exclude a hypothetical "as efficient" competitor is abusive. The "as efficient" competitor is a hypothetical competitor having the same costs as the dominant company. Foreclosure of an as efficient competitor can in general only result if the dominant company prices below its own costs.

Hence, whilst the intention is to measure the total ongoing economic costs that an efficient competitor would need to cover in order to make a profit in the long term (including the costs of production, sales and distribution, advertising and marketing, and central administration), the starting point will typically be the dominant company's own audited (or management) accounts.

## The price of loyalty

The Commission's discussion paper recognises that it may be difficult to calculate ATC because of certain common costs in a multi-product firm. In these circumstances, it proposes to "...allocate common costs in proportion to the turnover achieved by the different products unless other cost allocation methods are for good reasons standard in the sector". However, when undertaking a self-assessment, a company should question the suitability of this proposal for its business. Such allocations would only approximate to the true economic costs of a product if the "common costs" in question were in fact scaleable (i.e., they would increase in line with the size of the business). But in the presence of economies of scale and/or scope in the supply of multiple products, such allocations would be inherently arbitrary. They would also be inconsistent with the Commission's proposed cost benchmark in relation to other potentially exclusionary practices, such as product bundling practices, which is the long-run incremental cost (LRIC) of supply.

Further adjustments to a company's accounting data may be required, particularly in relation to capital costs. This need arises because the book value of assets in audited accounts will only reflect their economic value where the assets are not subject to technological change and have not seen significant price inflation or deflation. Moreover, the accounts will typically omit intangible assets (such as intellectual property or brands), which can sometimes form a substantial part of a company's actual capital base.

Finally, in implementing the "as efficient" competitor test, thought should be given to whether it would be appropriate to adjust a company's costs (upwards) in the light of any intrinsic advantages that may arise from holding a dominant market position. According to the Commission's discussion paper:

...it may sometimes be necessary in the consumers' interest to also protect competitors that are not (yet) as efficient as the dominant company. Here too the assessment does not (only) compare cost and price of the dominant company but will apply the as efficient competitor test in its specific market context, for instance taking into account economies of scale and scope, learning curve effects or first mover advantages that later entrants can not be expected to match even if they were able to achieve the same production volumes as the dominant company.

This is a controversial issue, which should not deny a dominant company any cost savings that should also be achievable by an efficient rival. A self-assessment exercise can reasonably confine such adjustments to clearly identifiable incumbency advantages, which result directly from a position of dominance, and which would be expected to create a fundamental asymmetry between the cost bases of the dominant firm and an efficient rival.

#### WHAT IS THE "COMMERCIALLY VIABLE SHARE" OF RIVALS?

Traditionally, when considering the legality of retroactive conditional rebate schemes, the European Commission and Courts have focused their attention on sales close to the target threshold, emphasising that:

- the lower the effective price compared to the average price of the dominant supplier, the stronger the loyalty-enhancing or "suction" effect;

## The price of loyalty

- the “suction” effect is strongest on the last unit of sales before the threshold is reached; and
- if the form of the rebate scheme implies an incremental region of sales (close to the target threshold) with an effective price which is very low or negative, then foreclosure can be presumed.

However, this final point should not be taken for granted, as the Commission’s discussion paper recognises: “...what is relevant...is not competition to provide an individual unit, but the foreclosing effect of the rebate scheme on commercially viable amounts supplied by (potential) competitors of the dominant supplier.” Whether rivals will in fact be foreclosed depends on the quantity they could hope to sell. The greater the rival’s “commercially viable share”, the higher the “effective price”, as it can spread the sum needed to compensate the customer for the loss of its rebate over a larger sale base. The discussion paper appears to accept that low (or negative) effective prices close to the target threshold will not have the effect of excluding competitors if they are able to sell through this range of sales to the point at which the effective price is above cost.

Critical, therefore, to an effective self-assessment will be an understanding of the customer’s natural purchase patterns and rivals’ natural ability to increase sales. The central question is what element of the customer’s purchases from the dominant firm will be “assured”. Of relevance will be constraints on both the capacity of rivals and the willingness of customers to switch. This aspect of a self-assessment should be closely linked to the market analysis upon which a finding of dominance could be based.

The Commission’s discussion paper suggests that:

... the actual market shares of competitors and their shares of the customers’ requirements, may make it clear whether the rebate scheme is able to have a foreclosure effect. In case the shares of the customers’ requirements purchased from actual rivals are smaller than the required share, the rebate scheme is likely to have a foreclosure effect where there is in addition no indication that these rivals are less efficient.

However, while existing market shares may provide a lower bound to the assessment of a commercially viable share, one should not assume that every unit of sales that a rival fails to achieve is necessarily assured to the dominant firm. For example, if the rival has a share in one retail account that is substantially above its aggregate market share, the reasons for this should be explored: does this suggest that the rival is capable of supplying more in other retail accounts, and so has a “commercially viable share” greater than its aggregate market share?

#### ADAPTING THE FRAMEWORK TO FIT REAL-WORLD SCHEMES

The stylised example in Box 1 was based on a rebate for exclusivity. In practice, rebate schemes will often require customers to commit to less. Although recognising that such schemes may also have foreclosing effects, the Commission gives little guidance. The implication of rebates that do not require exclusivity is that a proportion of sales to each customer is unaffected. What does this imply for the “required share” of rivals, where they already make sales to customers?

A possible approach would be to assess the number of units that a rival would need to supply in total in order (a) to compensate the customer for the loss of the dominant firm's discount and (b) for its average price across all of its sales to cover ATC. (This would, effectively, mean calculating the "required share" by reference to the customer's total requirements.) However, this approach could be criticised for failing to consider whether it would be rational, profit-maximising behaviour for a rival to sell through the target threshold. The rival might make higher profits by not doing so. And the Commission's recent negative decision in Prokent/Tomra<sup>3</sup>, which is currently subject to appeal before the Court of First Instance, casts doubt on whether this interpretation would be accepted.

So, as an extension, one might also assess the number of units that a rival would need to supply in order to make the same amount of profit that it would have made supplying volumes up to the point at which the rebate threshold bites. (In other words, the average price across all of these additional sales would need to cover additional costs of supply.) In this case, the rationale for using ATC as the relevant cost benchmark is less obvious. A rival will not be foreclosed if it is able to cover its incremental costs on additional sales beyond the target threshold.

Moreover, while the example in Box 1 was based on the case of a single competitor, a large firm will often face a number of smaller rivals. Again, the discussion paper offers little guidance. A possible approach would be to compare the "required share" against the existing market share of each individual rival (as a proxy for their "commercially viable shares").

#### BOX 2: THE EFFECT OF A REBATE SCHEME WITH MULTIPLE RIVALS

Let's assume that:

- A customer has total requirements for 1m Wizznuts a year.
- The dominant supplier faces four smaller competitors. Last year, its sales accounted for 80% (i.e., 800,000 units) of the customer's requirements.
- The dominant supplier has an ATC of 75p, a list price of £1 per Wizznut, and offers a rebate of 5% on all its purchases, on condition that the customer takes an additional 10% (i.e., 100,000 Wizznuts) of its total requirements.

This offer would be worth £45,000 to the customer. To match this without cutting the price below 75p, rivals would need to sell an additional 180,000 Wizznuts. None of these rivals individually can meet the (additional) "required share" of 18%, and therefore compensate the customer for the loss of the dominant firm's rebate while still covering ATC.

However, if each rival offered a price of 75p per Wizznut, then the customer should be indifferent between (i) choosing to buy an additional 100,000 Wizznuts from the dominant firm, thereby securing the rebate, and (ii) choosing to buy an additional 45,000 lower-priced Wizznuts from each of the dominant firm's four rivals. In combination, these rivals can meet the "required share" and profitably sell through the discount; it does not follow that any one of them is automatically foreclosed.

This test would effectively require that each of the dominant firm’s rivals be able to supply sufficient volumes so as individually and profitably to compensate the customer fully for the loss of the dominant firm’s rebate. However, this may be unduly restrictive.

Box 2 shows that, if a dominant company faces more than one competitor, what may matter in practice is the combined ability of the dominant firm’s rivals to compensate the customer for the loss of the dominant firm’s rebate, not their individual capabilities. Again, the key measurement issue is identifying the proportions of the dominant firm’s sales that are assured and contestable.

## CONCLUSIONS

The Commission’s discussion paper signals a departure from its traditional approach. It recognises that if a retroactive conditional rebate scheme implies a region of sales where rivals might need to offer an incremental price below cost, it does not necessarily follow that they will be foreclosed. Low (or negative) effective prices close to the target threshold will not have the effect of excluding competitors if they are able to “sell through” this range of sales to an effective price above cost.

This bulletin has not sought to question the desirability of the Commission’s proposed framework. Instead, a number of important implementation issues have been identified, which firms operating across Europe will face if they are to self-assess their rebating practices. Our experience of advising has taught us that self-assessment exercises, while not straightforward, may reveal valuable information about the likely competitive effects of alternative pricing schemes.

## SOURCES

- <sup>1</sup> “DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses”, December 2005
- <sup>2</sup> “Case C-95/04 P”, 15<sup>th</sup> March 2007.
- <sup>3</sup> “Prokent/Tomra, a textbook case? Abuse of dominance under perfect information” European Commission Competition Policy Newsletter, Number 2 – Summer 2006.

<b>CONTACT</b>	<b>Zoltan Biro</b> zoltan.biro@frontier-economics.com
	<b>Rachel Webster</b> rachel.webster@frontier-economics.com
	Frontier Economics Ltd
	<b>FRONTIER ECONOMICS EUROPE</b> BRUSSELS   COLOGNE   LONDON
	<a href="http://www.frontier-economics.com">www.frontier-economics.com</a>