Competition Competence Report

Modernisation of Article 102 TFEU: Use of Economic Analysis for Conditional Rebates

The process of modernisation has reached Article 102 TEFU. In February 2009 the European Commission published the "Guidance on the Commission's enforcement priorities in applying Article 82 (now 102) of the EC Treaty"[1] which outlines the new effects-based approach to exclusionary conduct by dominant undertakings under EC antitrust law. The focus of this CCR is on a special category of exclusionary conduct, namely rebate schemes.

Relevance of Rebates

For suppliers, rebate schemes are an important tool to boost sales by providing incentives to customers. Customers benefit from rebates through lower prices. On the other hand, unbalanced rebate systems may damage the positioning of a product on the market, distorting consumer choices or delaying the introduction of innovative products. Most importantly, rebates granted by a company that enjoys a dominant position on the market have the potential to force actual or potential competitors out of the market.

Rebate Schemes in the EU Commission's Guidance Paper

The guidance paper provides an analytical framework for the assessment of conditional rebates, defined as rebates granted to customers to reward them for a particular form of purchasing behaviour. The Commission distinguishes **incremental rebates** (once a target has been met, rebates are granted to the additional purchases) and **retroactive rebates** (once a target has been met, rebates are granted on all purchases).

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[1] OJ C 45, 24.2.2009

When rebates are granted by a dominant company they can have negative **foreclosure effects** on actual and potential competitors. A dominant company could use rebate schemes to protect its position on the market by making it difficult for competitors to compete on the contestable sales (the amount of sales for which the customer may prefer other suppliers). Alternatively, the dominant company could use rebate schemes to force competitors out of the market in order to be able to charge higher prices in the future on the full demand range.

According to the EU Commission, **foreclosure effects** are more likely if:

- The dominant company applies <u>retroactive rebates</u>: retroactive rebates make it less likely that customers switch to an alternative supplier for small amounts of demand;
- Competitors are not able to compete on equal terms for the entire demand of each individual customer: the dominant company may use the <u>'non contestable' part of the demand</u> of each customer as leverage to decrease the price to be paid for the 'contestable' part of demand;
- The dominant company grants <u>substantial rebates</u>: The higher the rebate as a percentage of the total price and the higher the threshold, the stronger is the incentive effect for customers to exceed the threshold;
- The dominant company applies <u>individualised thresholds</u>: the dominant company can tailor thresholds so that it becomes economically disadvantageous for a customer to switch to alternative suppliers.

"As-efficient-competitor-test"

When assessing the potential anti-competitive effects of a rebate system the EU Commission applies e.g. the **as-efficient-competitor-test**: the Commission investigates whether the discounted price is below a certain measure of cost so that equally efficient competitors could not compete with the dominant firm. In line with the general approach to exclusionary conduct, the guidance paper highlights the average avoidable cost (AAV) and the long-run average incremental cost (LRAIC)[2] as benchmarks. The Commission compares the effective price[3] that a competitor would have to

[2] AAC (Average avoidable cost) is the average of the costs that could have been avoided if the company had not produced a discrete amount of (extra) output, in this case the contestable part of demand. LRAIC (Long-run average incremental cost is the average of all the (variable and fixed) costs that a company incurs to produce a particular product.

[3] The effective price that the competitor will have to match is not the average price of the dominant undertaking, but the normal (list) price less the rebate the

offer in order to compensate the customer for the loss of the conditional rebate if he/she switched part of its demand with the AAV and LRAIC of the dominant company:

- P > LRAIC: the rebate is not capable of foreclosing equally efficient competitors;
- AAC < P < LRAIC: other factors have to be examined to conclude that entry or expansion of equally efficient competitors is affected, e.g. realistic and effective counterstrategies;
- P < AAC: as a general rule, foreclosure effects of equally efficient competitors are very likely.

Efficiencies

Finally, the Commission examines claims by dominant companies that the rebate systems achieve **efficiencies**. Cost efficiencies or other efficiencies have to be passed on to consumers. Efficiencies are considered more likely with:

- Standardised volume targets;
- Incremental rebate schemes;
- Evidence that the rebate scheme is necessary for the dominant company to make certain relationship specific investments in order to be able to supply those retailers.

These considerations are generally in line with the economic theory behind rebate schemes. Incremental rebates give incentives to customers while allowing recovery of fixed costs. Volume targets can be an effective way for supplier to reward promotional activities carried out by retailers. Nevertheless, this is holds not only for standardised targets, but also for individualised ones. From an economic perspective, there is no reason to believe that individualised rebates are more harmful to competition and to consumers.

Relevance of competition law enforcement

Non-compliance with Article 102 can lead to significant fines. In March 2006, the European Commission has imposed a fine of € 24 million on Norwegian group Tomra for violating EC Treaty competition rules on the abuse of a dominant position. The Commission has found that Tomra abused its dominant position in the market for the supply of machines for

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customer loses by switching, calculated over the relevant range of sales and in the relevant period of time.

the collection of used drink containers in return for a deposit, usually installed in retail outlets, in Austria, Germany, the Netherlands, Norway and Sweden. The Commission concluded that Tomra's practices, consisting of i.a. loyalty-inducing discounts, restricted or at least delayed the market entry of other suppliers.

Article 102 may be applied both by the European Commission and by national courts if a company is found to be dominant on the relevant market. Therefore, it is essential for companies with high market shares to verify that the rebate scheme that they apply, or intent to apply, complies with the legal requirements. A thorough economic assessment is required to judge whether a rebate scheme comply with EU law, in line with the new modernized approach. With the"more economics based approach" or "effects-based" approach, the impact of the rebate scheme on competition is the decisive criterion. The **economic effects on the market** of the rebate scheme need to be assessed individually and may diverge case by case. Economic analysis produces legal certainty and allows exploiting the positive effects of rebates.

EE&MC Approach to Rebate Systems

The EE&MC approach to the assessment of rebates starts with a preliminary assessment of a company's existing rebate scheme. EE&MC then proceeds to verify compliance with EU law in line with the "more economics based approach". If the rebate scheme proves to be problematic, EE&MC develops an individual rebate-point system which complies with the law and supports the company's strategic goals. In a third step, the new (revised) rebate scheme is implemented.

The idea behind a rebate-point system is to let retailers "earn" rebate points as a reward for certain behaviours that generate an economic benefit for the supplier. The economic effects of the rebate-point system are simulated through a rebate model which is accessible to both the producer and the retailer. The following rebates are examples of such possible rebates:

- Presentation Rebates

  Rebates are conditioned on the favourable presentation of the supplier's products in retail outlets: retailers can earn rebate points by e.g. increasing the shelf space for the relevant product, use of the supplier's exposition shelf, or by separating the relevant product from private labels.

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- Distribution Rebates

  Rebates are granted to reward a faster listing of new products or for increased sales volumes within a retailer's outlet.

- Promotion Rebates

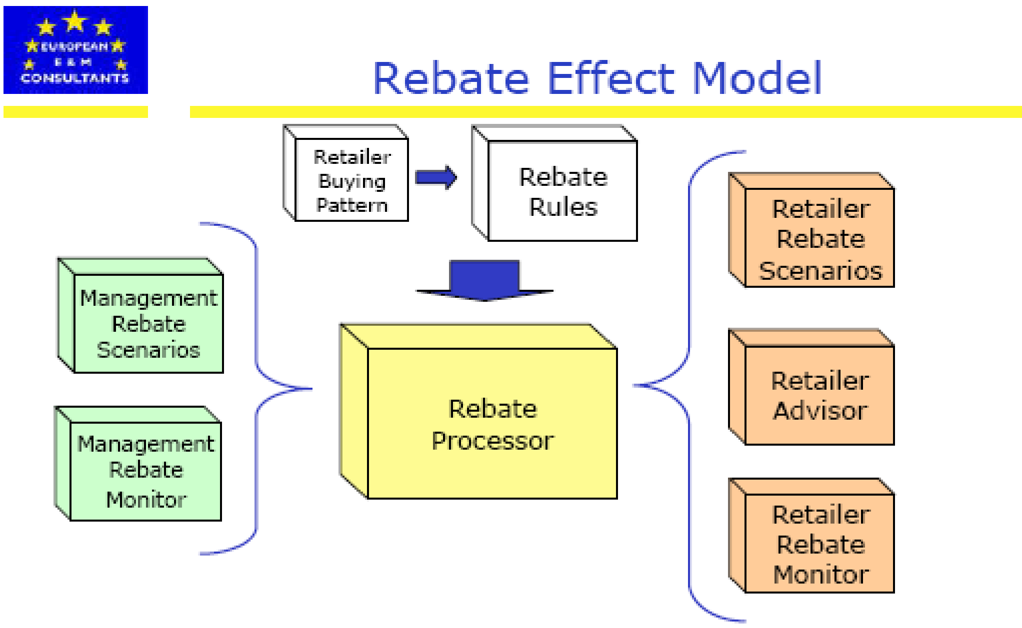
  Rebates are granted as a reward for promotional activities.

- Logistics Rebates

  Rebates are conditioned to the payment or ordering behaviour of retailers, for example, ordering full trucks or eliminating inter-company transports.

In a first step, EE&MC rebate-point system assigns points to retailers that fulfil pre-defined and transparent behavioural criteria. In a second step, rebate points are weighed according to the strategic importance that the supplier assigns to this particular rebate/behaviour. Finally, the sum of the weighed rebate points is transposed to a percentage rebate. The supplier can then simulate the effects of the new rebate system in the EE&MC rebate model (see graph below).

Graph 1: EE&MC Rebate Model



Based on the actual buying pattern, retailers' performances as a result of the rebate criteria defined in the "Rebate Rules" are simulated. The results of the pre-defined rebate rules are illustrated in the rebate processor:

both rebate points and the percentage of the rebates are calculated. The "management rebate monitor" shows producers the total gain that retailers might earn as reward for their behaviour (total amount or rebates). By changing the rebate rules, the producer can simulate various "what-if" scenarios on hypothetical retailer behaviour in the "management rebate scenarios". The results of these scenarios are again shown in the "management rebate monitor". Also, retailers can monitor the effects of their actual and/or hypothetical behaviour ("retailer rebate scenarios"). The actual rebate generated by the retailers' behaviour is shown in the "retailer rebate monitor". However, retailers cannot change the rebate rules and do not have access to the results of other retailers. On request, the "retailer advisor" proposes recommendations on how to adjust the retailer's behaviour in order to maximise rebates.

Conclusion

To conclude, undertakings can benefit from the new approach of the EU Commission towards rebate systems. The abolishment of per se rules and implementation of an effect-based approach gives the possibility to manufacturers/ suppliers to accomplish strategic objectives to the benefit of consumers. The EE&MC rebate point system is developed according to the legal rules: it assures compliance with legal requirements and, at the same time, it helps suppliers to realise the full potential of a rebate system.

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