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COMPETITION COMMITTEE**

FIDELITY REBATES

--Background note by the Secretariat--

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More documentation related to this discussion can be found at www.oecd.org/daf/competition/fidelity-rebates.htm

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FIDELITY REBATES

*Background note by the secretariat**

Abstract

In recent years there have been important cases in different jurisdictions that have contributed to a rich debate on the approach to adopt when examining fidelity rebates (sometimes referred to as loyalty discounts). This background paper is intended to draw practical lessons from that debate. The paper explores why it is that firms use fidelity rebates. It identifies some rationales that potentially benefit consumers, for example, these schemes often reduce prices, and can help to achieve efficiencies. However, it also identifies that these schemes can sometimes harm consumers. Firstly they can be part of an exclusionary strategy, for example predation, de facto exclusive dealing, or taxing rivals' prices. Secondly, they can be a way to soften competition with rivals. The paper then examines the legal framework in which fidelity rebate cases take place, and identifies the objectives, standards and presumptions that determine the relevant assessment. It then sets out an analytical framework for assessing the exclusionary effect of fidelity rebate schemes. The paper concludes by identifying the implications for prioritising investigations.

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1. Introduction

1. Since the Competition Committee last discussed fidelity rebates in 2008 there have been important cases in different jurisdictions, court rulings, administrative guidance documents and notices. This has all contributed to a rich debate on the right approach to adopt when examining fidelity rebates. This background paper is intended to draw practical lessons from that debate.

2. Fidelity rebates can have ambiguous effects on consumer welfare. Assessing the impact of rebates on the freedom of firms to compete is therefore unlikely to be a good approximation of their likely effect on consumers. Similarly, presumptions on the competitive effects of exclusivity rebates are also unlikely to be reliable. Assessing whether a rebate scheme operated by a firm with market power induces some buyers to purchase exclusively does not tell us whether consumers do better or worse because of that exclusivity.

3. Creating a safe harbour based on a price cost test is likely to lead to anti-competitive activity going unchallenged. Fidelity rebates, unlike predatory pricing, can be used to discourage trade with rivals, even to exclude them, by raising their costs (or taxing their prices) without the need for a phase of profit sacrifice. This makes these strategies a less risky and more successful exclusionary practice than predation. The scope for consumers being harmed by fidelity rebate schemes that remain within a safe-harbour is therefore greater than from predatory pricing. At the same time, the scope for consumers to benefit from these schemes appears narrower than is true of simple price cuts, and the risk that the absence of a safe-harbour would chill price competition is smaller than in the case of predation. For example, there are alternative ways to cut price that carry little risk of challenge such as simple price cuts or simple incremental quantity rebates. Moreover, fidelity rebates introduce price differences based on loyalty, they do not necessarily introduce price cuts; the need to avoid chilling the introduction of price differences is less clear than it is for price cuts. The case for a safe harbour based on price being above cost is therefore a weak one. It would be too lenient and would prioritise predatory cases over de facto exclusive dealing cases that seem likely to be a more common way to exclude rivals.

4. We describe a growing literature setting out circumstances in which fidelity rebates soften competition between rivals rather than seeking to discourage trade with rivals. Given this literature, it might be sensible to put additional weight on complaints from buyers, rather than rivals. There are a number of other useful indicators for making prioritisation decisions. These include schemes involving intermediate buyers, retroactive rebates, share of need rebates, and schemes in which the price for disloyal consumers is higher than the price that would likely be set absent the rebate scheme.

5. The paper begins in section 2 by defining its terminology. Section 3 explores why it is that firms use fidelity rebates and identifies some rationales that potentially benefit consumers and some that do not. Section 4 then examines the legal framework in which fidelity rebate cases take place, and identifies the impact that the objectives, standards and presumptions of this framework will have on the assessment that follows. Then, using a consumer welfare objective and a rule of reason approach, Section 5 sets out an analytical framework for assessing the exclusionary effect of fidelity rebate schemes. Section 6 concludes and identifies the implications for prioritising investigations.

2. Definitions

6. Fidelity rebate or loyalty discount schemes allow sellers to offer buyers a better price conditional on the buyer demonstrating loyalty in the purchases they make. Whether these preferential prices constitute a price reduction for loyal customers or reflect the introduction of a price penalty for disloyal customers depends on the price that would be charged in the absence of the scheme.

7. The terminology for different types of conditional pricing practices remains unsettled and different terms are often used to describe schemes that reward some definition of loyalty.¹ For clarity in this paper, we define “share of need rebates” as those schemes in which loyalty is measured according to the share of a buyer’s purchases of a single product that are made from the seller. Where the threshold is at or close to 100 per cent, these are sometimes referred to as “exclusivity rebates”.² These exclusivity rebates differ from exclusivity agreements since the buyer does not commit to purchasing exclusively from the seller; however, they may nevertheless successfully incentivise the buyer to do so. We define schemes that measure loyalty without reference to a buyer’s total purchases as “quantity rebates”. We note that rebates can be standardised, that is to say, the same terms are available to all customers, or they can be set relative to an individualised target. In those cases, we refer to “target rebates”. Finally, we use “retroactive rebates” to identify price adjustments that apply retrospectively to all units purchased when a specified threshold has been reached.³ In contrast, we use “incremental rebates” to describe adjustments to price paid on units over and above a threshold.

8. We focus on the challenges in assessing share of need rebates (or de facto share of need rebates). Share of need rebates are different in form and potentially also in effect from other conditional pricing practices such as quantity rebates. This is because they are conditional not only on the quantity purchased from the seller, but also on the quantity purchased from its rivals. As a rule, vertical contracts that reference rivals are more likely to attract antitrust scrutiny than other vertical agreements.⁴ We will see in section 3.2.3 for example that share of need rebates can damage competitive incentives to expand the market as well as the incentives to compete for a greater share of an existing market. In contrast, quantity rebates would not affect the competitive incentives to expand the market. Nevertheless, if market expansion incentives are not relevant and an individual buyer’s total demand is predictable then target quantity rebate schemes can be designed to effectively mirror a share of need rebate (see box 1 for an example).⁵ In those circumstances we treat the rebate as a de facto share of need rebate since the assessment challenges are broadly the same. In the next section, we ask why firms use fidelity rebates.

Box 1. The Tomra case⁶

In 2006, the European Commission found that the Norwegian group Tomra abused its dominant position in the market for reverse vending machines (RVMs), and fined Tomra €24 million.

Tomra had been the dominant supplier of RVMs since 1972, with a market share exceeding 95% in Europe since 1997. Since customers and their procurement process were predominantly organised at national level, the European Commission concluded that the relevant geographical markets were national in scope.

From 1998 to 2002, Tomra implemented a system of exclusivity agreements, quantity commitments and fidelity rebates in Austria, Germany, the Netherlands, Norway and Sweden. Specifically, Tomra:

- concluded **exclusivity agreements** with a number of its customers for the supply of RVM solutions,
- concluded agreements with its customers imposing upon them an ‘**individualised quantity target**’ that corresponded to the customer’s total or almost total demand for RVM solutions in a specific period of time. The customers were granted rebates subject to their commitment to purchase the agreed target quantity,
- concluded agreements with the retail companies establishing ‘**individualised retroactive rebate schemes**’, thresholds of which corresponded to customers’ total or almost total demand.

With respect to the three different practices, the Commission noted, respectively:

- **Exclusivity obligations** have by their nature a foreclosing capability. In the specific case, given Tomra’s dominant position and the share of the demand to which the scheme was applied, the agreements were capable of having and in fact had a market distorting foreclosure effect.

- **Individualised quantity targets** corresponding to the entire or almost entire demand, and fidelity rebates in general (defined as rebates that are conditional on customers purchasing all or most of their requirements from a dominant supplier) have the same effect as explicit exclusivity clauses. In the specific case, Tomra was able to estimate each customer's approximate demand and set thresholds equal to the customer's entire requirement or to a large proportion of them. The Commission also noted that it is not decisive for the exclusionary character of agreements or conditions whether the purchase volume commitment is expressed in absolute terms or with reference to a certain percentage thereof.
- The combination of a **retroactive rebate system** with thresholds corresponding to the customer's entire requirement, or a large proportion of them, represented a significant incentive for buying almost all the equipment needed from Tomra and artificially raised the cost of switching to a different supplier. Therefore, the rebate schemes were loyalty building.

The Commission concluded that Tomra abused its dominant position since the alleged practices “aimed at eliminating or at the very least preventing the entry and/or the expansion of its competitors. Tomra purposefully employed the practices in question as part of its exclusionary policy.”⁷

Tomra appealed against the decision at the EU General Court, and subsequently at the Court of Justice of the European Union (CJEU), on the grounds that the Commission failed to prove that Tomra's practices had an actual anticompetitive effect, and that they led to prices which were lower than its costs. Tomra also argued that the agreements were not ‘foreclosing’ because its rivals could still compete for customers who were not covered by the agreements. Both the General Court⁸ and CJEU⁹ upheld the Commission's decision, in 2010 and 2012 respectively.

3. Theoretical Context: Why do firms use fidelity rebates?

9. In this section, we look at why it is that fidelity rebates are such a commonly used device. We first set out the rationales that firms might have that may benefit consumers. For example, those in which a firm seeks to increase profits by improving efficiency or the value that it offers in order to encourage buyers to trade with the firm. We then identify those that might not benefit consumers. For example, rationales in which a firm seeks to increase its profit, not by improving its efficiency or the value it offers, but by finding other ways to discourage buyers from trading with a rival (foreclosure). In addition, we consider ways in which firms might use fidelity rebates to increase profits by discouraging rivals from competing against them and thereby softening competition (rather than seeking to exclude rivals).

3.1 *Using fidelity rebates to increase efficiency or the value offered*

10. Firms might adopt a fidelity rebate scheme for four reasons that potentially benefit consumers.

11. The first reason is that fidelity rebate schemes can give distributors an incentive to increase their effort to sell the seller's product. This may better align the incentives of the distributor with those of a seller who cannot observe the buyers' actions and thereby help resolve a moral hazard problem. This can in turn provide a seller with confidence that any buyer-specific investments that it makes will not be open to free riding by rival sellers. For example, fidelity rebates can deter distributors from using the seller's investment to advertise and increase sales of all products including those of rival sellers. This might increase the seller's willingness to invest in buyer-specific investments that benefit consumers. However, there are other ways to align incentives and protect buyer-specific investments; for example, suppliers might pay a distributor a commission on sales (effectively an incremental standardised quantity rebate). It is therefore important to understand why firms might prefer a fidelity rebate scheme and in particular whether exclusivity rebates are necessary or whether a standardised quantity rebate might be equally effective.

12. A second reason is that some fidelity rebates, for example incremental quantity rebates, can represent a competitive response, for example to a price cut. For example, a firm may find it unprofitable

to respond by competitively reducing its price on all units, but it may be profitable to reduce its price on those units that it can produce more cheaply (for example when economies of scale are present). Therefore, a firm that finds itself under competitive pressure from a rival might react by adopting a quantity rebate scheme in order to price closer to its marginal cost. For this reason, a frequent concern of US courts when examining fidelity rebate cases is the risk of deterring firms from responding to competitive incentives.¹⁰

13. The third reason for using a fidelity rebate scheme is that a seller can use the scheme to identify those purchases (or those customers) that are more price sensitive. This may allow it to price discriminate and offer lower prices on those purchases (or to those customers). By price discriminating the seller can competition for those additional purchases, and ensure that more of these marginal transactions occur and that buyers and sellers each obtain additional gains from trade. Whether or not this benefits consumers as a whole will depend on the prices that would be charged and the output in the absence of the scheme.¹¹ If the additional sales made through price discrimination generate economies of scale for the supplier then, if the market is competitive, these might be passed onto all consumers through lower prices.¹²

14. It is not at first glance obvious why share of need or exclusivity rebate schemes, rather than incremental quantity rebate schemes would be necessary to price discriminate in this way. However, in markets where total retail demand or individual retailer demand is not stable or easily predictable they can move risk from buyers to the seller. This might improve the responsiveness of buyers to the incentives set out in the scheme. In addition, retrospective rebates can create particularly powerful incentives for a buyer to increase purchases as it approaches a threshold. In the absence of information on demand, setting thresholds based on share of need, rather than on quantity might better identify the buyers' marginal sales. This might help to target the more powerful incentives at those marginal sales and hence increase the number of marginal transactions that take place.

15. Finally, a seller might decide to use a share of need rebate in order to stimulate downstream competition, for example to remove double marginalisation.¹³ A standardised share of need rebate could give cut prices not only to large loyal buyers but also to relatively small buyers who might not qualify for a standardised quantity rebate. A small buyer might be more willing to participate and sacrifice its variety in order to obtain a lower price since this may help it compete more effectively with a larger buyer.¹⁴

16. Since there are circumstances in which fidelity rebates can be used to compete harder with rivals, they are likely to sometimes draw complaints from rivals that would prefer not to compete. However, in the next section we will see that fidelity rebates can also be used to restrict the ability of rivals to compete effectively.

3.2 *Using fidelity rebates to discourage trade with a rival (foreclosure)*

17. There are four traditional ways for a firm to discourage trade between its rivals and its buyers, and one way that has only recently been articulated.^{15,16} The four traditional ways are exclusive dealing, tying/bundling, predation, and refusal to supply/margin squeeze. Rebates can be used in three of these strategies; however, bundled rebates are outside the scope of this paper. Therefore, we can think of fidelity rebates as being used either as part of a strategy to exclude rivals through predatory pricing; or as part of a strategy to reduce competitive pressure through exclusive dealing. However, in addition to these two traditional methods, we also identify a third way for a firm to discourage trade between its rivals and its buyers. We call this "taxing rivals' prices". In section 5, we will discuss the way in which to test these three theories in the context of fidelity rebates. In this section, we briefly set out the three theories themselves and relate them to fidelity rebates.

3.2.1 *Discouraging trade through predation*

18. The theory of predation is that a firm temporarily sacrifices profit to create prices that are low enough to discourage buyers from purchasing from rivals and thereby deter entrants and/or force rivals from a market, at which point the firm can increase its prices and profit.¹⁷ According to this theory, the firm would sacrifice profit in the short term in order to increase its profits in the longer term. While the predator does not necessarily need market power in order to launch a predatory strategy, it would need to be confident that in future it would have sufficient market power to recoup the profits that it sacrifices. For example, the strategy would not be rational if, having successfully deterred entry the firm would still need to continue to deter new potential entrants since it would be unable to recoup the profit that it sacrifices. The theory also requires there to be some asymmetry that means the predator can outlast its victims. For example, this might involve differences in access to resources. It also requires an explanation of why buyers voluntarily participate in a scheme that reduces competition between sellers and ultimately leads to buyers paying higher prices. Potential answers to this question might include buyers not having the required information on firms' costs to understand the consequence of their purchases.

19. If a predatory strategy is effective, it can lead to exclusive dealing, which can exclude rivals by denying them sales. Before the lack of sales leads to the rival exiting, it may increase the rival's costs by denying them economies of scale, and hence reduce the competitive constraint the rival imposes on the predator's price during the predatory period. In order to take advantage of this reduced competitive pressure and increase its profits during the predatory period, the predator would need to increase its price. However, if it were to do so it would lose the exclusivity that it achieved by setting a predatory price. Therefore, under a predatory strategy, the predator must offer attractively low prices during the predatory period and cannot exploit the impact this might have on its rivals' costs.

20. One way to interpret fidelity rebates is to see them as a variation on a predatory strategy. A firm could implement a predatory strategy by reducing all unit prices. However, if the predator makes some sales that are non-contestable, in the sense that rivals cannot hope to attract them, then it might prefer to use fidelity rebates to reduce its profit sacrifice without damaging the effectiveness with which it excludes a rival. The amount of profit sacrificed is less because the rebate is only applied to some proportion of sales. Meanwhile, the exclusion is no less effective because the rival cannot in any case compete for the non-contestable sales regardless of their price.

21. Most jurisdictions agree that fidelity rebates offer an alternative way to implement a below cost pricing strategy (rather than simply reducing the list price). Where the allegation is that the price, once the effect of rebates is included, is below cost there is a good degree of consensus that the standard analytical framework for predatory pricing is applicable. Successful enforcement of such an approach would prevent firms from using a fidelity rebate scheme to predate whilst preserving the appearance of non-predatory list prices. Notably, classic predation cases such Brooke Group in the US involved the application fidelity rebates.¹⁸

3.2.2 *Discouraging trade through exclusive dealing (or de facto exclusive dealing)*

22. A predatory strategy provides a temporarily high value product that induces buyers to switch and forecloses rivals. In contrast, a firm using an exclusive dealing strategy can also raise rivals' costs and potentially exclude them, but in some circumstances it can do so without profit sacrifice, and in other circumstances it can do so by sacrificing a profit on some sales whilst increasing profits on other sales, thereby increasing overall profits. This means that no recoupment phase is necessary in an exclusive dealing case. This also means that exclusive dealing agreements do not need to go as far as to exclude a rival; they can simply make it more difficult for them to compete effectively.

23. An example in which profit sacrifice is unnecessary is that of an incumbent with a first mover advantage who approaches buyers sequentially offering them exclusive contracts (a ‘divide and rule’ strategy). In those circumstances, we can expect buyers to accept the exclusive deal in order to ensure they are not reliant on an entrant that is unable to reach minimum viable scale.¹⁹ This is a theory of customer foreclosure in which exclusive dealing restricts access to customers.

24. Similarly, and even in the absence of economies of scale, an incumbent with market power may agree exclusive deals with the most efficient input suppliers. This vertical agreement might be interpreted as ‘co-ordinated/collusive’ in a sense. For example, the supplier might agree to exclusive dealing that raises the costs of rivals to the incumbent firm, and hence allows the incumbent to increase its profit.²⁰ In exchange, the incumbent might agree to compensate those suppliers by setting higher retail prices for final consumers and splitting the additional profit with the suppliers. This is a theory of input foreclosure in which exclusive dealing restricts access to the key inputs required for production.²¹

25. The difference between customer and input foreclosure is set out in figure 1. In each case, the shaded red line is the exclusive deal that by its nature blocks the existence of a relationship with a rival. For example, in customer foreclosure, an exclusive dealing agreement between an upstream firm and a downstream firm denies an upstream rival access to a downstream customer. The lack of sufficient customers to obtain economies of scale can increase the upstream rival’s costs and reduce competitive constraints on the upstream firm who can increase its price. In input foreclosure, an exclusive dealing agreement denies a downstream rival access to the inputs it wants to buy from an upstream firm. If the inputs from the upstream firm are particularly important, for example, they are more efficient or better quality than inputs from other upstream firms; this can increase the downstream rival’s costs and reduce the competitive constraints on the downstream firm who can increase its price.

Figure 1. Customer and Input Foreclosure



26. Intermediate buyers such as distributors can be interpreted either as being the downstream customers of a producer, or as upstream suppliers of an input to the producer (the input being the supply of distribution services). Therefore fidelity rebate schemes aimed at intermediate buyers can generate concerns over both input and customer foreclosure.

27. If an incumbent can agree exclusivity, it might be able to raise its rivals’ costs without cutting its own price – indeed it might even be able to maintain exclusivity while raising its own price. This means that unlike in predation, the firm can increase profits at the same time as discouraging trade with the rival (rather than having to wait for a recoupment phase). This makes the strategy less risky and more likely to succeed. As a result, exclusive dealing is generally a more important priority for many competition agencies than predatory pricing. Classic exclusive dealing agreement cases include Dentsply (US),²² and Van den Bergh Foods (EU),²³ though interestingly an exclusive dealing agreement between Amazon and Apple is currently under examination in Germany.²⁴

28. One way to interpret fidelity rebates is to see exclusive dealing agreements as a special case of fidelity rebate in which the buyer has to make 100 per cent of purchases from the supplier in exchange for some payment. This suggests that share of need and exclusivity rebates should, if found to lead to de facto exclusive dealing, be assessed in the way that exclusive dealing would be assessed.²⁵ As with exclusive dealing agreements, fidelity rebates can be used to induce exclusivity without setting effective prices that undercut those rivals (see the ‘divide and rule’ and ‘co-ordinated’ mechanisms in para 23 and 24 above). This can again raise rivals’ costs, increase their prices, and reduce the competitive pressure on the firm’s own prices. As noted above this in turn allows the firm to shift its price schedule upwards (that is both the price for loyal buyers and the price for disloyal buyers), while maintaining the differential in the schedule in order to continue to gain exclusivity.

29. While there are circumstances in which no profit sacrifice is required for exclusivity rebates to harm consumers, there are also circumstances in which a profit sacrifice on some sales will also raise rivals’ costs, increase the firm’s profit, and potentially harm consumers. In these cases, price-cost tests that were originally designed to identify predatory pricing can, with significant modification, be used to test whether fidelity rebates are likely to have harmful effects on consumers.

3.2.3 *Discouraging trade through taxing rivals’ prices*

30. By moving away from theories applying to traditional predation and exclusive dealing, it is also possible to think about fidelity rebates as discouraging trade between buyers and rivals by effectively adding a tax to the price of additional purchases from a rival. For example, to buy from a rival, a purchaser has to pay the rival’s price as well as to incur an opportunity cost from losing the rebate it would have earned on its purchases from the firm in question. Obviously, any competitively low price imposes a small tax on more expensive rivals’ sales in this respect since purchasing from the rival means paying the rival and incurring an opportunity cost from the lower price that could have been paid. The difference in this case is the size of the tax imposed by a retroactive rebate, and the fact that the tax is built upon non-contestable sales. The loss of the rebate might therefore be significant for the buyer and the seller’s rival might not be able to match it, and may therefore find that buyers reduce the output they demand (without having any effect on the rival’s costs).

31. This tax effect can occur either when a buyer is choosing between purchasing a product of a firm with market power and one of its rivals, or when a buyer is deciding whether to purchase a product from a rival or not to purchase at all. In the first case, the tax can reduce the competitive constraint that the rival imposes upon a firm with market power; in the second, it can reduce total output. Farrell gives the following example:²⁶ suppose that in light of the fidelity rebate, the customer is purchasing 90 units from the firm with market power and 10 from the rival in order to achieve a “reward” that comes from purchasing 90% from the firm with market power. Now suppose that an entrant offers a new product that would lead the customer to wish to continue to purchase 90 units from the firm with market power but now purchase 15 units from the rival. The purchase of these additional five units from the rival does not come at the expense of the firm. Yet, even if the entrant were to offer the five units at cost, these purchases would be deterred because the customer would fall below the 90% trigger for the reward. In this way, the share of need rebate can directly reduce output.²⁷

32. This theory was identified in the US Federal Trade Commission’s analysis to aid public comment on the proposed consent order on the fidelity rebates used by Intel (2010)²⁸ and Transitions Optical (2010).²⁹

3.3 *Using fidelity rebates to discourage a rival from competing*

33. In section 3.2, we have focused on the different ways in which a fidelity rebate might be used to discourage trade with a rival; however, certain types of fidelity rebates may also be used to soften competition with a rival. These theories do not appear to have featured in recent cases, yet they might fit the facts of specific cases in future. As such, we will review them here.

34. The first theory is that the firm uses a share of need rebate to discourage retailers from switching to a rival seller's product when it tries to reduce intra-brand competition on its own product by raising the wholesale price.³⁰ To see this consider a producer that competes with a rival producer, both producers sell to distributors who then compete with one another. If the producer wants to remove intra-brand competition, then ideally, it would prefer not to raise its wholesale price; instead, it would prefer to remove intra-brand competition by setting a two-part tariff. This two-part tariff would have a wholesale price that induces distributors to set retail prices that maximise the product's profitability, and a fixed fee to extract the distributors' profit. However, the firm is unable to set this fixed fee because distributors would respond by substituting to the rival producer's product. Instead, the best the firm can do is to reduce intra-brand competition on its product by setting its wholesale price above marginal cost. If it does so then in response, the distributor might again threaten to switch to another product. However, by using a share of need rebate, the seller can specify that: a) the wholesale price that is set above marginal cost is only available to loyal buyers that purchase a specific share of their needs from the seller, and, b) distributors that switch to other products pay an even higher wholesale price. This can stop distributors switching products whilst allowing the producer to set a wholesale price to loyal buyers that is above marginal cost. Notably, the effect of this rebate is not that the distributor purchases exclusively from the seller, but rather that it sells at a higher retail price.

35. In the second theory, the rebate scheme is used as a focal point and information-sharing device to help facilitate co-ordination. For example, it may signal that a firm is willing to settle for a specific share of the market at a high price rather than to compete to expand that share.³¹ In setting this share, the firm will need to leave room for another firm to operate in the remaining portion of the market; therefore, the share cannot be an exclusive one. For example, a firm might set a high price to 50 per cent and introduce incremental rebates for those buyers that purchase up to 60 per cent of their total purchases. This creates strong incentives to increase purchases at volumes just below 60 per cent but weak incentives to purchase much more than 60 per cent. In this scenario, a rival firm that observes the terms of the scheme faces a choice on whether to serve the remaining 40 percent of the market at a high price or to cut prices to compete to increase its share at the expense of the first firm. Since the rebate scheme is a share of need rebate it also requires that the buyer inform the seller how much it purchases from rivals. This can help the sellers to understand whether rival sellers are deviating from a collusive agreement by selling to buyers that they agreed not to. If these factors help the firms to co-ordinate on their respective market shares, for example by improving monitoring and strengthening the punishment of deviations, then they may be able to preserve higher prices provided it is difficult for new entrants to disrupt the co-ordination.

36. In a third theory, a firm uses fidelity rebates to commit to maintaining a price differential.³² It wants to divide the market and charge a higher price to loyal consumers than it otherwise would be able to, and therefore wants to avoid having to reduce its price to compete for all consumers (including disloyal, marginal consumers). To do so, it uses a fidelity rebate scheme to reduce its incentive to compete on price for disloyal customers. In particular, the rebate scheme might allow it to commit to charging disloyal customers a higher price than that charged to loyal customers. This would mean that to cut its price and compete for disloyal customers the firm would also need to reduce its price to loyal customers. This reduces the firm's incentive to compete for disloyal buyers and may therefore help to strengthen an agreement to divide the market between the firm and a rival that sells to disloyal buyers. For this theory to apply the rebate scheme would need to be set relative to any future price charged to disloyal buyers rather

than to a specified price (since this would not prevent the firm from cutting this price and competing for disloyal customers). In this sense, the rebate scheme has a most-favoured-nation element that is necessary for the theory of harm to apply.

4. Pre-assessment: the relevant legal framework

37. Fidelity rebates are one of the most difficult areas of antitrust. The assessment of their effect will depend on both the facts of the case and on the objective pursued. Before setting out an analytical framework for assessing the exclusionary effects of fidelity rebate schemes, we therefore discuss the legal framework in which fidelity rebate cases take place. We first identify the different potential objectives of the framework, the standards that it uses and the impact that these have in distinguishing between pro and anti-competitive rebates. We then identify some presumptions that would also affect the assessment.

4.1 Identify the relevant objective

38. The type of assessment that is required depends on the objective or purpose of the investigation. The objective of competition law is a large and complex discussion in itself and goes beyond the scope of this paper.³³ In this section, we present just a brief overview of the different objectives of competition law since this underlies some of the recent controversies over fidelity rebate schemes.

4.1.1 Consumer welfare

39. By setting out to protect consumer welfare an agency can focus directly on the effects of fidelity rebates on welfare itself rather than proxies for welfare. By protecting consumer welfare specifically, an agency can contribute a pro-consumer counterweight to firms' representation of their interests.³⁴ It can also reduce the risk of political intervention and regulatory capture.³⁵ Protecting consumer welfare can also help to maximise total welfare (though some would prefer that antitrust agencies sought to protect the welfare of both consumers and shareholders).³⁶

4.1.2 Competitive process

40. In Europe, the Treaty on the Functioning of the EU (TFEU) pursues consumer welfare indirectly through the protection of the competitive process (see box 2 on Intel case). It has been argued, however, that the objective of the TFEU was not to protect consumer welfare but instead to preserve a process in which competitors are free to compete without distortions.³⁷ If this were the case, then the assessment that is required is one that identifies the effect of a rebate on the freedom of firms to compete, rather than the effect of the rebate on consumer welfare. This focus on the fairness of the competitive process rather than the outcomes of that process is sometimes referred to as an *ordo-liberal* approach.³⁸

41. While it is certainly true that the objective of the EU competition rules is "a system of undistorted competition", it is not clear whether this means that: a) competitive outcomes should be protected; b) a competitive process should be protected because it reduces the risk of anticompetitive outcomes; or c) a competitive process should be protected for its own sake. As a result, many reject the suggestion that the objective of the TFEU is the protection of the competitive process.³⁹ What is clearer is the interpretation that the European Commission and the European courts have adopted. For example, in relation to price restrictions they have taken a much more relaxed approach to maximum resale price restrictions than they have to minimum resale price restrictions despite these practices being equally problematic in restricting retailer's freedom to set price. This suggests that the greater risk of consumer harm from minimum resale price restrictions has been found to be relevant and that the rules are protecting outcomes and not just process.

Box 2. The Intel case⁴⁰

In 2009, the European Commission found that Intel Corporation infringed Article 82 (now Art. 102 TFEU) of the EC Treaty by abusing its dominant position on the x86 central processing unit (CPU) market, and imposed on Intel a fine of € 1.06 billion. The investigation was launched in 2004, following a formal complaint submitted by Advanced Micro Devices (AMD), Intel's only significant competitor. The Commission investigated two types of conduct:

- *Conditional practices*: Intel granted a series of rebates to four computer manufacturers (Dell, HP, Lenovo and NEC) conditional on them purchasing all or almost all of their supply needs from Intel. In addition, Intel awarded payments to Media Saturn Holding, Europe's largest PC retailer, conditional on them selling exclusively computers with Intel x86 CPUs.
- *Naked restrictions*: Intel also made direct payments to three manufacturers (HP, Acer, and Lenovo) to stop or delay the launch of specific AMD-based products and/or to limit the sales channels available to these products.

In its analysis, the Commission stated that Intel's rebates were "de facto conditional upon those companies purchasing all or nearly all of their x86 CPUs (at least in a certain segment) from Intel."⁴¹ It said that these findings, "in the absence of any objective justification, are in themselves sufficient to find an infringement under Article 82 of the Treaty according to the case law."⁴²

In addition to showing that the conditions of the case law for finding an abuse were fulfilled, the Commission conducted an as-efficient-competitor analysis. This approach reflected the 2009 *Guidance on the Commission's enforcement priorities* (see box 3). The Commission noted however that the document did not apply in this case since it was adopted after the launch of the investigation.

The as-efficient-competitor analysis allocated Intel's total rebate to the estimated contestable portion of demand. It found that an as-efficient-competitor would have had to offer its x86 CPUs to customers at a price which was below its average avoidable costs in order to match Intel's offer. The Commission concluded that Intel's rebates were capable of having or likely to have anticompetitive foreclosure effects.⁴³

Regarding the naked restrictions, the Commission concluded that Intel's conduct directly harmed competition, and consumers ended up with less choice than they would have had in the absence of Intel's practices, which in addition were not linked to any legitimate objective justification or efficiency.

In 2014, the General Court rejected Intel's appeal and upheld the Commission's 2009 Decision.⁴⁴ The General Court also rejected the need for an as-efficient-competitor test, and in general of an economic analysis of the actual effects in cases like this, in order to establish violation in case of rebates such as those granted by Intel. Intel has appealed against the judgement, and this appeal is now pending before the CJEU.

4.2 Identify the standard

42. If the objective of the investigation is to protect consumer welfare then a number of tests or standards have been proposed to help distinguish between conduct that harms consumers and conduct that does not. The type of assessment that is appropriate will again depend on the standard that is used. In section 5, we set out the assessment that follows if we use a consumer welfare standard. However, we note that other standards might be adopted.

4.2.1 Consumer welfare standard

43. A consumer welfare standard seeks to understand the likely net effect of alleged anticompetitive conduct on consumers. The standard requires a balancing of any anticompetitive effect that it identifies with any countervailing efficiencies that are found to benefit consumers. In the event that the agency is satisfied that both effects exist then it would compare the relative magnitude of the two effects.⁴⁵

4.2.2 *Equally efficient competitor standard*

44. An alternative to a consumer welfare standard is an “equally efficient competitor standard”. This seeks to ensure competition law protects only equally efficient competitors (and does not offer protection to inefficient competitors) as a means to protect consumer welfare. For example, it would withhold this protection from inefficient firms, not for the sake of the efficient firms themselves, but because doing so would risk creating ways for inefficient firms to avoid competing in ways that benefit consumers, for example by complaining. Similarly, some argue that protecting inefficient firms would in any case not benefit consumers since these firms would impose little competitive constraint on the more efficient firms.

45. There are likely to be significant overlaps between the practices that are found harmful under this standard and a consumer welfare standard. However, a major weakness of the standard is that it treats firms with market power too leniently. It is clear for example that this standard will in some cases fail to protect consumer welfare. For example, take a monopolist with a marginal cost of \$50 and a price of \$100. If there were a less efficient entrant with a marginal cost of \$75 that were able to enter the market then consumer welfare would be higher. We might expect the entrant to enter and the market price to fall, or we might expect the monopolist to limit price at \$74 in order to remove the opportunity for the entrant while continuing to earn a \$24 mark-up. In either case, consumers would benefit from the monopolist not being able to remove the threat of entry or to increase the costs of the entrant.⁴⁶ Furthermore future consumer welfare may also be improved by preventing firms with market power from foreclosing less efficient rivals that might if they were allowed to survive long enough become equally or more efficient. The standard also has the troubling implication that consumers purchasing from less efficient firms that are forced from the market by a firm using its market power to reduce competition and increase profits (for example by raising rivals’ costs or predating), were somehow making mistakes. Furthermore, by removing the ability of consumers to continue making such mistakes the firm has in fact helped rather than harmed them.⁴⁷

Box 3. EU Guidance on exclusionary abuses⁴⁸

In February 2009, the European Commission published its “Guidance on enforcement priorities in applying Article 82 (now 102) of the EC Treaty to abusive exclusionary conduct by dominant undertakings” (the guidance).

The Guidance sets out a general approach to exclusionary conduct. This began with the question of whether a firm had market power, and hence a dominant position with special responsibilities, which it might abuse. It clarifies that the aim of the Commission is to ensure that firms with market power should not use it to foreclose competitors, as foreclosure has an adverse effect on consumer welfare.

The guidance identified a range of factors that would generally be relevant to its examination of exclusionary practice as including:

- a) the strength of the dominant position of the firm;
- b) the presence of economies of scale or scope, network effects, and barriers to entry;
- c) the competitive constraint from the dominant firm’s rivals;
- d) the degree to which the conduct is targeted at selected customers or suppliers;
- e) the extent of the practice (duration, magnitude);
- f) evidence that foreclosure has been occurring; and,
- g) evidence of exclusionary strategies.

The guidance noted that foreclosure is more likely where there are non-contestable sales that can be included within a retroactive rebate scheme in order to persuade buyers to purchase exclusively. It is worth emphasising that inducing exclusivity in this way can allow the dominant firm to increase its average price and its profit.

The guidance identified that conditional rebates can have foreclosing effects without necessarily entailing a sacrifice by the dominant firm, and in this regard require a different assessment from that of predation (para 37). However, the guidance suggests that the Commission would normally not consider problematic a rebate that leaves the effective price of contestable units above its own long run average incremental cost, as it would allow an equally efficient competitor to compete (paragraph 43).⁴⁹ Therefore, despite recognising that there are circumstances in which less efficient competitors exert a constraint that should be taken into account (paragraph 24), it appeared that the Commission would use a predatory pricing approach, albeit a modified one, when prioritising fidelity rebate cases.

Since then the General Court of the European Union (GCEU) and the Court of Justice of the European Union (CJEU) have each rejected the use a price-cost test as a necessary condition for finding fidelity rebates to be abusive (See box 1 on Tomra, box 2 on Intel, and box 8 on Post Danmark II).

4.2.3 *Profit sacrifice standard*

46. A profit sacrifice standard states that conduct should be considered unlawful when it involves a profit sacrifice that would be irrational if the conduct did not have a tendency to eliminate or reduce competition.⁵⁰ The test is both over-inclusive and under-inclusive. It is over-inclusive because it can prohibit certain types of behaviour that exclude competitors but also increase consumer welfare. For example, research and development costs for a new drug may be so high that spending the money to develop it would be rational only if the drug is so effective that it excludes competitors and gives the innovating firm market power. On the other hand, some conduct may entail no short run profit sacrifice at all yet still be harmful to competition. As a result, while useful in some contexts, the test does not provide a general foundation for distinguishing between competitive conduct and exclusionary conduct.⁵¹

4.2.4 *No economic sense standard*

47. The no economic sense standard states that conduct should not be condemned unless it would make no economic sense but for a tendency to eliminate or lessen competition.⁵² This test does not require profit sacrifice and so does not have the same weaknesses as the profit sacrifice test. The test might be used offensively, that is, to argue that conduct was exclusionary because it made no economic sense otherwise. However, it is less clear whether it can be used defensively, that is to demonstrate that conduct should not be condemned because it did make economic sense. For example, the test would clear conduct that makes economic sense because it reduces competition *and* increases the defendant's efficiency.

4.3 *Identify any relevant presumptions*

48. Recent fidelity rebate cases also illustrate that the type of assessment that is required depends on whether the legal framework applies any presumptions to the schemes in question. In section 5, we set out the assessment that follows from taking a rule-of-reason approach and identifying all the circumstances of a case in order to form a view on the likely effects of a specific scheme. However, we note that in some recent cases courts have applied presumptions that make this assessment unnecessary.

49. One potential presumption is that any exclusivity rebate scheme used by a firm with market power will be presumed to have harmful effects. This means that an analysis of the likely effects is unnecessary (see box 1 on Tomra and box 2 on Intel). There are two potential reasons for adopting such an approach.

- Firstly, this presumption might reflect a view that a particular class of rebate schemes (for example exclusivity rebate schemes) are anticompetitive in and of themselves.⁵³ In this view, a class of rebate schemes might be presumed to be harmful if they can have no other purpose, other than an anticompetitive one. Some restrictions that a firm might impose may fall into this

category. This would be, for example, the case for “naked restrictions” such as Intel paying customers to delay the introduction of a rival product (see box 2), or Tomra preventing customers from testing a rival product (see box 1). While a restriction by object of these practices makes the administration of the rules easier for the enforcement agency, some authors have pointed out that exclusivity rebate schemes and exclusivity agreements can reflect rivalry and as such generate efficiencies. They argue that we cannot assume that the object of these restrictions is necessarily an anticompetitive one.⁵⁴

- A second reason is if the court takes the view that the form of rebate scheme, when employed by a firm with market power, is not anticompetitive in and of itself, but is highly likely to be anticompetitive in effect.⁵⁵ In these circumstances, the burden of proof might be reversed and an anticompetitive effect presumed providing there is a robust assessment of market power.

50. These presumptions are generally open to rebuttal with evidence of efficiencies.⁵⁶ They therefore do not necessarily correspond to a “per se” conclusion of illegality.⁵⁷ However, section 5.4 identifies the challenges in successfully making the case for efficiency justifications. First, however we set out a framework for assessing the exclusionary effects of fidelity rebates.

5. A framework for assessing the exclusionary effects of fidelity rebates

51. In this section, we set out a framework for assessing the exclusionary effects of fidelity rebates. This framework therefore reflects the three theories of harm articulated in section 3.2. We do not set out a framework for the theories of harm in section 3.3 since these have yet to be applied. It assumes that the objective is to protect consumer welfare, and that there are no automatic presumptions that remove the need to assess the effect that a fidelity rebate scheme has on consumers.

52. Courts in the US have suggested that the selection of the relevant theory of harm should depend on the predominant method of exclusion. However, in putting this into practice they have sometimes decided that one method (predation) was predominant despite the alleged mechanism and the facts of the case suggesting that exclusion occurred through a different mechanism (See box 4 on Eisai/Sanofi). In these circumstances, an assessment of one of the potential theories that does not find the scheme to be harmful would not be sufficient to reject a complaint. This is because the scheme may still prove to be harmful under a different theory. While a cautious approach might be to examine the facts under each theory in turn, a more practical approach would be to require that complainants identify and evidence the theory of harm in their complaint, and to examine the alleged theory.

Box 4. The Eisai/Sanofi case⁵⁸

In 2014, the Judge Cooper of the U.S. District Court District Of New Jersey ruled on a case concerning the market for brand name pharmaceuticals used to treat blood clots in patients with deep vein thrombosis. Eisai sued Sanofi based on Sanofi’s alleged anticompetitive and monopolistic conduct in its marketing of its drug Lovenox. During the relevant period, from 2005 to 2010, Lovenox had a share of 81.5 to 92.3 per cent of the market.

The conduct under scrutiny was a scheme involving both quantity and share of need rebates that Sanofi offered to the purchasers of Lovenox. Specifically, the rebate increased with (i) the number of units purchased, and (ii) the share of Lovenox in the customer’s total purchases of drugs in Lovenox’s Therapeutic Class. The latter was defined as the rolling four months of units of Lovenox purchased by the customer divided by the rolling four months of units of all products purchased by the customer within the Lovenox Therapeutic Class market. Therefore, for example, a hospital purchasing a gross sales volume between \$100,000 and \$399,999, assuming that this amount represents 82% of the hospital’s needs in the category, would receive a 15% rebate on the price. A hospital purchasing the same volume, but for whom it represents 91% of need, would receive a 21% rebate.

Unlike *ZF Meritor/Eaton* (see box 6), here the Court argued that price, rather than exclusivity, was the predominant mechanism of exclusion. For example, the conduct did not induce exclusivity through means other than price, and customers could easily terminate the contracts on short notice. They therefore argued that a price-cost test applied.

It was undisputed that after the rebates were applied, Sanofi did not sell Lovenox to hospitals at a price that was below Sanofi's incremental cost. The Court noted that in 2009 for example, Sanofi was able to charge a price that was 17.7 times higher than its costs, while Eisai charged 7.8 times its cost.

According to the judge's reasoning, the finding that price was above cost was enough to dismiss the case. However, she also affirmed that, even without using the price-cost test, the case would have been dismissed because the circumstances did not prove the risk of foreclosure. This was shown, for example, by the increase in the market share of Sanofi's rivals during the relevant period, the absence of customers' testimony of foreclosure and the fact that some hospitals switched away from Lovenox without consequences. Judge Cooper concluded that when Eisai chose to discount more, it was able to win more customers, and said that the antitrust laws do not protect Eisai's desire to preserve an 85% profit margin.

5.1 *If the alleged mechanism is predation through pricing below cost*

53. If the allegation is that the rebate scheme forecloses by setting price below cost then it can be tested under a standard predatory theory of harm.⁵⁹

54. Predation can harm consumers if profits are sacrificed in order to foreclose a rival.⁶⁰ Notably this does not require that the firm incur losses, only that it makes less profit than it might otherwise have done.⁶¹ However, in order to avoid chilling price competition it is instead standard practice to test whether the alleged predator incurs genuine losses. This requires a comparison of the price with cost, usually the average variable cost. In the context of fidelity rebates, the total rebate should be deducted from the total price charged to the customer. If prices were genuinely set below cost, and rivals are unable to compete, then any potential pro-competitive rationale for doing so should be considered. For example, promotional pricing might be used to clear obsolete or perishable inventory. In the absence of a pro-competitive rationale, the likelihood of recoupment should be assessed. For example, this might involve an assessment of barriers to entry or the ability of rivals to survive a price war.

Box 5. The Velux case

In 2009, the European Commission abandoned an investigation into potential infringements by Velux, a Danish manufacturer of roof windows. The decision was taken a few weeks after the unofficial publication of the *Guidance on the Commission's enforcement priorities* (the guidance), but prior to publication in the Official Journal.

In an article discussing the case officials of the Commission explained that Velux offered up to 5 per cent incremental rebates to builders merchants based on the volume they purchased, normally over a six-month period.⁶² The scheme was stepped, with the rebate increasing by 0.2%–0.5% when a higher threshold was met. The thresholds were slightly different from country to country, but within each country, the same thresholds were offered to all distributors.

Consistent with its guidance, the European Commission applied a price-cost test and found that even the highest rebate (5 per cent) was unlikely to result in sales below incremental cost. The officials cited paragraph 43 of the guidance as suggesting that in those circumstances a rebate is normally not capable of foreclosing an equally efficient competitor in an anti-competitive way.

In this case, it is notable that the rebates were incremental rather than retroactive. Similarly they were not individualised and therefore were not comparable to a share of need rebate or an exclusivity rebate. The Commission concluded that the rebate scheme was unlikely to be exclusionary and closed the case.

5.2 If the alleged mechanism is de facto exclusive dealing

55. As in an assessment of contractual exclusive dealing agreement, this requires evidence on market power and four questions:⁶³ whether the rebate leads to de facto exclusivity; whether exclusivity raises rivals' costs; what impact increased costs have on competition and market outcomes; and why rivals were not able to match such a scheme.

56. The first question is whether the scheme creates de facto exclusive dealing (or de facto partially exclusive dealing, see box 6 below on ZF Meritor/Eaton), and with whom.⁶⁴ This requires identification of the different buyers' purchasing patterns (or equally the suppliers' selling pattern if the exclusive dealing is with an input supplier) and an understanding of how and why these differ from the purchasing behaviour that would have been likely absent the rebate scheme.⁶⁵ This may be observable from data and through information from the buyer; however, it may also require an assessment of the strength of the incentives set out in the scheme for each buyer. For example, how significant is the size of the rebate? Is the scheme individualised? Is it retroactive? Does the firm have non-contestable sales? Does the rebate cover both non-contestable and contestable sales? How long does the scheme last?⁶⁶

Box 6. The ZF Meritor/Eaton case⁶⁷

In 2012, the US Court of Appeals for the Third Circuit affirmed a district court finding that Eaton's conduct in the heavy-duty truck transmission market in North America violated the Sherman Act and the Clayton Act.

In 2000, Eaton entered new long-term agreements with the four direct purchasers of heavy-duty truck transmissions. The agreements granted fidelity rebates conditioned on the buyer purchasing a minimum percentage (varying between 70% and 90%) of its needs from Eaton. As a result, ZF Meritor, Eaton's only competitor, started losing market share and eventually exited in 2007.

The Appeal Court ruled against Eaton despite evidence that prices had remained above cost. The reason, the Court explained, is that in this case price was not the clearly predominant mechanism of exclusion. The exclusionary effect reflected a range of factors in addition to prices such as Eaton's position as a necessary trading partner, the long duration of the contract, and the existence of high barriers to entry in the market. The court ruled that these practices as a whole resulted in de facto partial exclusive dealing.

The decision was criticised in a dissenting opinion by Justice Greenberg who said that the plaintiff's failure to show that price was below cost should have been sufficient to dismiss the case. A group of 18 academics supported this view in an amicus brief to the Supreme Court⁶⁸, where the authors argued that the Court's approach "will chill sellers from offering conditional non-predatory discounts and rebates, reward less efficient producers, diminish price competition, and harm consumer welfare."⁶⁹ In response to this criticism, many academics endorsed the Eaton/Meritor decision and recommended that agencies should use a "raising rivals' costs" framework to assess fidelity rebates and not a predatory pricing framework.⁷⁰ The Supreme court declined to hear the appeal.

57. Having established that the scheme induced an increase in exclusive or partially exclusive dealing, the second question is whether that exclusivity increased the costs of rivals.⁷¹ For example, if the concern were that access to customers had been foreclosed and this increased costs, then relevant questions would include: what proportion of buyer purchased exclusively? Was it possible for rivals to sell to other buyers? Are there barriers to entry into markets in which intermediate buyers operate (can the firm bypass these intermediate buyers or sponsor entry)? Is there evidence to support the conclusion that there are economies of scale? When do these economies of scale begin to apply? When do they expire? Where is minimum viable or minimum efficient scale? Does the scheme preclude rivals from reaching it? If the concern were that access to inputs had been foreclosed and this increased costs, then further relevant question would include: which input suppliers became exclusive? Why did this increase the rivals' costs? Was it possible for rivals to find other suppliers (are there barriers to entry into the supply of this input)? Were these suppliers more efficient or better quality than those that remain available? Did the same happen

to other rivals? Did other sellers respond by changing their price? The key issue is not the fraction of distribution that is foreclosed, but whether the foreclosure will raise the rival's costs.⁷²

58. In each case, direct evidence of the impact on costs themselves is particularly valuable. However, when observing the impact of the rebate on firms' cost data it is necessary to consider what would have happened to costs absent the rebate scheme. This can help to clarify which observed cost shifts are attributable to the rebate scheme and which are not.

59. The third question is whether and to what extent an increase in costs translates into reduced competition. While some effect might be assumed, a more detailed understanding may help determine the magnitude of the effect. This might involve an examination of industry data to understand what happened to prices, quality, innovation or output when costs increased. It might also involve using firms' cost and price data to understand how in the past or in a simulated future prices would have been set if costs had been different, for example what price changes would have been passed onto consumers. Evidence of impact on market structure is also useful. Since the rebate scheme might have been used to defend an incumbent's existing ability to continue to charge excessive prices, it may also be relevant to consider whether absent the rebate scheme competition might have been expected to intensify, for example due to new entry or innovation. Evidence to suggest that the price charged to disloyal customers is above the level at which it would have been set absent the fidelity scheme might be a useful indicator of a harmful scheme.

60. Finally, the assessment needs to explain why rivals were not able to match a scheme that posed such a threat.⁷³ In effect, the question here is why the rival could not compete for exclusivity with a customer/supplier (or similarly why those customers/suppliers would not choose to trade with the rival rather than a dominant firm seeking to increase prices). In light of the theory discussed in section 3.2.2 it may be that it is for the same reason that a firm with market power can sometimes raise its rivals' costs without sacrificing profit. For example:

- The rival might be a less efficient producer but with a differentiated product that still exerts a competitive constraint that means that the use of fidelity rebates to raise its costs would harm consumers. In these cases, a further assessment of the competitive constraints imposed by rivals would be necessary to identify those whose foreclosure would be harmful. However, this is perhaps more straightforward than trying to identify those rivals that given time and scale would be equally efficient.
- Distributors might fear that they will be disadvantaged if other competing distributors trade with the incumbent and the rival becomes inefficient due to customer foreclosure. Moreover, the incumbent might induce this fear by offering individualised rebates at different times and without making information available.
- Distributors might fear that they will be disadvantaged if the rival becomes inefficient due to the incumbent successfully foreclosing the rival's access to key inputs (distributors or other inputs).
- Unlike the incumbent, the rival might not be willing and/or able to collude/co-ordinate with intermediate buyers to gain collectively by raising prices charged to final consumers.⁷⁴

61. There can also be asymmetry in what the firms are bidding for when they offer rebates and hence their willingness to offer rebates, which can also reduce rivals' ability to compete for exclusivity. For example, a dominant firm may be willing to bid more to protect its market power than an entrant would be willing to bid to earn competitive profits (see example in box 7 below). However, this asymmetry can be addressed by conducting a modified price cost test. This modification would mean a test that does not ask whether the rebates would lead to the dominant firm incurring a loss (even on just its contestable units), as

proposed in the *Guidance on the European Commission's enforcement priorities*.⁷⁵ Instead, the test would ask whether the rival could profitably remain in the market given the price it would need to set to neutralise the impact of the monopolist's rebate. As noted there are a range of circumstances in which this foreclosure might harm consumers even if the foreclosed rival is not equally efficient. The test may identify whether these rivals would be foreclosed, but it does not identify whether their foreclosure would be harmful to consumers.

Box 7. Example: Asymmetry in willingness to offer rebates

Say a monopolist with two distributors is earning a profit of \$200 but faces entry that would result in it becoming one of two duopolists earning a profit of \$70 each. The monopolist could provide up to \$130 in rebates to induce exclusivity and maintain its profit. In contrast, an entrant needs non-exclusive access from one distributor to be viable. Therefore, the entrant would be willing to provide rebates up to \$70 for non-exclusive distribution (at which point its price would equal its cost). This means the monopolist could therefore outbid the entrant and offer rebates worth \$71 to obtain exclusivity. The cost of rebates worth \$71 would not result in losses for the monopolist since it could pay them out of its \$200 profits.

In this example, a modified test would consider whether the rival, given its own prices and costs, could match the total rebates that the monopolist offers to protect its monopoly. This would show that by providing rebates worth \$71, the monopolist, while pricing well above its own cost, was foreclosing the rival by forcing them to price below their own costs.

62. Alternatively, it might be the case that the dominant firm has sacrificed profit in some sales in order to gain exclusivity and increase its total profit. It is worth emphasising that in these cases the firm seeks to increase its profit rather than incurring a loss that would require recoupment at a later date (those cases would be examined in section 4.3). In these circumstances, the 'discount attribution' test can be used to understand whether the profit sacrifice on sales of non-contestable units that is required to exclude an equally efficient competitor is in parallel recouped through additional sales of contestable units.⁷⁶

63. To conduct this test, you attribute the total value of a seller's rebates on its non-contested units to its sales of contested units. This reflects the idea that the rebates on non-contested units are not offered in order to secure the sale of those units, these are, after all, non-contestable, but rather they are offered in order to sell contestable units. If the seller's profits on contested units, including the costs of funding the reattributed rebates, exceed the costs of selling the contested units, then the seller offering the rebate is able to exclude even an equally efficient rival and thereby increase its profit. The test can also be modified in order to understand whether a less efficient rival can be excluded while the firm maximises its profit. While not determinative, the test can therefore be one of a range of useful analytical tools (see box 5 on Velux and box 8 on Post Danmark II).⁷⁷

Box 8. The Post Danmark II case⁷⁸

In 2009, Denmark's Competition Council found that Post Danmark had abused a dominant position on the market for the distribution of bulk mail by applying rebates on direct advertising mail. It found that this had the effect of tying customers and 'foreclosing' the market.⁷⁹

Post Danmark applied a retroactive quantity rebate scheme, with rebate rates from 6% to 16% according to the number of items sent per year. The rebate scheme was standardised, i.e. the minimum threshold to obtain a rebate was the same for all customers. The scheme therefore would not be expected to mirror the effects of a share of need or exclusivity rebate.

Following Post Danmark's appeal, the Danish Supreme Court requested a preliminary ruling from the CJEU. The CJEU stated that the rebates offered by Post Danmark, granted on the basis of the aggregate orders placed over a given period, cannot be regarded as simple quantity rebates. It said that simple quantity rebates are linked solely to the volume of purchasing, are granted in respect of each individual order and in principle are not anticompetitive, since they correspond to cost savings made by the manufacturer. The CJEU said that Post Danmark's rebate scheme was also not what it called a "loyalty rebate": it noted that Post Danmark's rebate scheme did not entail "an obligation for, or promise by, purchasers to obtain all or a given proportion of their supplies from Post Danmark."⁸⁰ It therefore appears that the court considered that the scheme was not a share of need, or exclusivity rebate. Instead, the court considered the scheme to be a third type of rebate.

In the case of rebates such as Post Danmark's, the Court ruled that to reach an infringement decision, it is necessary to consider all the circumstances around the case. The Court seems therefore to suggest that there is a need to apply an analysis of the likely effects of such rebates on consumers. In regards to what type of analysis is necessary, the court suggested that the as-efficient-competitor test is one tool for the purposes of assessing whether there is an abuse of a dominant position in the context of a rebate scheme. However, it noted that there are others, and that the test is not a necessary condition for a finding that a rebate scheme is abusive, nor was it relevant in the case at hand.⁸¹

The CJEU also stated that the guidelines on enforcement priorities issued in 2009 by the European Commission is meant to be a useful tool for prioritisation, but not binding on national competition authorities and courts.⁸²

64. However, the test can be difficult to carry out. Unlike bundled rebate cases in which the attribution test is run across distinct products, in the case of loyalty rebates it is not straightforward to identify contestable and non-contestable sales. Concluding on what is contestable can therefore be extremely difficult. Similarly determining the right measure of cost is not straightforward in markets where marginal costs are low due to significant R&D costs (for example pharmaceuticals, software and microprocessors, see box 9 on Qualcomm). As a result reaching a conclusion on the results of the test can be challenging and may in any case prove inconclusive.

Box 9. The Qualcomm case⁸³

In 2009, the Korean Fair Trade Commission (KFTC) investigated Qualcomm's pricing practices in the market for CDMA (Code Division Multiple Access) technology licensing and modem chip/RF chips. It found that Qualcomm was dominant and had excluded its competitors and maintained its dominance through fidelity and bundled rebate schemes. It sought to bundle its modem chip with its CDMA licenses by charging discriminatively high royalties for using non-Qualcomm modem chips, for example: 5% for Qualcomm modem chips, 5.75% for non-Qualcomm modem chips. In addition, it also offered fidelity rebates on each product on condition that purchasers met the great portion of their demand with Qualcomm chips. For example, one company was required to purchase over 85% of the modem chips from Qualcomm in exchange for a rebate of 3% on the purchase.

The KFTC decided to impose corrective orders and a fine of 208 million dollars on Qualcomm for abusing its dominant position by charging discriminatory royalties and offering conditional rebates. In the analysis, the Korean authority did not use a price-cost test to assess the impact of rebates. During the hearing, Qualcomm submitted the results of a price-cost test that they had conducted which suggested price remained above cost. The KFTC rejected the analysis in its final decision after finding that the test was not applicable because it had several limitations. They also considered that the results of the test lacked credibility.

5.3 *If the alleged mechanism is an effective tax on rivals' prices*

65. The theory flows from the observation that to buy from a rival instead of a firm with a fidelity rebate, a purchaser has to pay the rival's price and an effective tax since it loses the fidelity rebate it would have earned on its other purchases.

66. In contrast to exclusive dealing or de facto exclusive dealing this does not require that any buyers are induced to purchase exclusively (paragraph 57 above), nor is it likely to affect the rivals costs' (paragraph 57-58). These requirements are instead replaced by a need to identify the size and scope of the tax that is imposed. To understand the size of the tax it is necessary to identify the percentage discount specified by the rebate scheme; whether the rebate is retroactive; and the thresholds at which the percentage discount increases. These three factors determine the value of the rebate that is lost when a buyer misses a specific threshold, and hence the size of the tax that is applied to the rival's sale of the unit that leads to the buyer missing that threshold (or the larger purchase that includes the sale of that unit).

67. We define the scope of the tax as the sales upon which it is imposed. This depends on the level of the thresholds in the rebate. For example if the buyer purchases 200 units and the first threshold is at 80 per cent and the second is at 90 per cent, and the firm faced a single rival, then the rival's sales that would be taxed would be the 20th to 40th sales. The sale of the first 19 units would not be taxed since the buyer loses no rebate by purchasing these units. Similarly, in the event that the buyer purchased 40 units, any further units would also not be taxed.

68. Having identified the scale and scope of the tax the next step is to understand whether the tax translates into a reduction in competition and an impact on market outcomes. This might involve an examination of industry data to understand what happened to prices, quality, or output when the tax was introduced (bearing in mind the likely counterfactual and the sales on which an effect would be expected). It might also involve using firms' price data to understand how in the past, or in a simulated future, changes in rival's actual prices affected how the firm set its prices. Again, the intention would be to understand the impact on the prices that both the rival and the firm using the rebate would set in the presence of the tax.

69. Finally as in raising rivals' costs, it is important to understand why rivals might not be able to compete, for example, why they are not able to react to the tax by cutting their prices to ensure their post-tax price remains competitive. As previously noted, the answer might be the same types of asymmetry that explain why a firm with market power can sometimes raise its rivals' costs through de facto exclusivity without them being able to respond (for example the existence of non-contested sales, see paragraphs 60-62).

5.4 *Evaluate possible efficiency justifications*

70. In the event of a finding that a fidelity rebate scheme discourages trade with rivals, or softens competition with rivals, an agency will wish to consider possible efficiency justifications. Since the information necessary for an agency to assess efficiency claims accurately is in the hands of the parties themselves, the burden of proof will be on the defendant. In addition to proving the existence of countervailing efficiency justifications, the defendant will also usually need to show that it could not achieve the same efficiency through practical, less restrictive means, and that the efficiency is passed through to consumers. It is also notable that even if these requirements are fulfilled some courts might reject efficiency justifications for anticompetitive conduct that did not actually motivate the firm to adopt the scheme.

71. The potential rationales for considering that fidelity rebates might benefit consumers were identified in section 3.1. Parties may therefore claim one or more of these rationales as efficiency justifications. However, in recent cases, few parties have decided to present any efficiency defence. Aside from the usual challenges in mounting an efficiency defence, a particular challenge in making an efficiency defence of a fidelity rebate scheme might be that the rationale for adopting the scheme is often to compete rather than to increase efficiency. This may therefore limit the scope for identifying countervailing efficiencies to weigh against a finding that the scheme reduces competition. Similarly, it might be difficult to argue that there are no less anticompetitive ways to cut price. At the very least, this would appear to require an explanation of why simple price cuts or incremental quantity rebates are in practice not possible.

6. Conclusion

72. Firstly, fidelity rebates can have ambiguous effects on consumer welfare. Distinguishing between pro and anti-competitive rebate schemes therefore requires an assessment of the effect on consumers. Assessing the impact on the freedom of firms to compete is unlikely to be a good approximation of their likely effect on consumers.

73. Secondly, presumptions on the competitive effects of exclusivity rebates are also unreliable. Assessing whether a rebate scheme operated by a firm with market power induces some firm's customers to purchase exclusively is just the first step of the analysis. It is the same as identifying that such a firm holds an exclusive dealing agreement. It does not tell us whether consumers do better or worse because of that rebate scheme.

74. Thirdly, it is right to prevent firms from avoiding examination of a complaint of predation by pursuing a predatory strategy using the cover of a fidelity rebate scheme to obscure the setting of prices at predatory levels. However, creating a safe harbour based on a price cost test as in predatory cases is likely to lead to anti-competitive activity going unchallenged. This is because fidelity rebates, unlike predatory pricing, can be used to discourage trade with rivals, even to exclude them, by raising their costs (and their effective prices) without the need for a phase of profit sacrifice.

- In some cases, a firm can discourage trade with an equally efficient competitor without making a profit sacrifice. For example, the firm might successfully use a 'divide and rule' strategy, or reach an agreement with downstream buyers to raise prices to final consumers. Price-cost tests based on the firm's costs are not helpful for identifying anticompetitive conduct in these cases.
- In other cases, a firm can discourage trade with a competitor without making a profit sacrifice. For example, the rival might be less efficient, or the firm might be willing to pay more to maintain its market power than a rival is to enter. A discount attribution test that uses the costs of the rival can be helpful in identifying anticompetitive conduct in these cases.
- Finally, in some cases, a firm can discourage trade with an equally efficient competitor by making a profit sacrifice on certain sales (though not sacrificing any of its total profit). A discount attribution test (using the firm's own costs) can be helpful for identifying anticompetitive conduct in these cases.

75. In each of these cases, there is no need for a recoupment phase, or for the rival to exit. This makes these strategies a less risky and more successful exclusionary practice than predation.⁸⁴ The scope for consumers being harmed by fidelity rebate schemes that remain within a safe-harbour is therefore greater than from predatory pricing.

76. At the same time, the scope for consumers to benefit from these schemes, particularly those requiring intermediate buyers to purchase a large share of their total requirement, appears significantly smaller than is true of simple price cuts. Furthermore, the risk that the absence of a safe-harbour on fidelity rebates would chill price competition is also smaller than in the case of predation. For example, there are alternative ways to cut price that carry little risk of challenge such as simple price cuts or simple incremental quantity rebates. Moreover, fidelity rebates introduce a price difference based on loyalty, they do not necessarily introduce price cuts; they can involve the introduction of penalty prices for disloyal consumers. The need to avoid chilling the introduction of price differences is less clear than it is for price cuts.

77. Moreover, a safe-harbour would ignore complaints that allege that prices are high and yet which are able to articulate (and support with evidence) economically sensible reasons why the complainant is still unable to undercut those prices. The case for a safe harbour based on price being above cost is therefore a weak one. It would be too lenient and would prioritise predatory cases over de facto exclusive dealing cases that seem likely to be more common and hence more likely to cause harm

78. Fourthly, we described a growing literature setting out circumstances in which fidelity rebates soften competition between rivals rather than seeking to discourage trade with rivals. These theories are unlikely to feature in complaints from rivals since they benefit the rival at the expense of the buyers. This might explain why these have yet to feature in investigations of fidelity rebates. Given this literature, agencies might be advised to put additional weight on complaints from buyers, rather than rivals. These would also have the added advantage that the motive for a buyer complaint is more transparent than one from a rival.

79. Finally, there are a number of useful indicators for making prioritisation decisions. The theories of harm discussed suggest that there is more scope for consumer harm from fidelity rebate schemes involving intermediate buyers (which create scope for input foreclosure and the possibility of vertical co-ordination at the expense of final consumers). Similarly, they support the widely held view that retroactive rebates and share of need rebates merit closer attention than incremental schemes and simple quantity rebates. Finally, investigation is worthwhile if the price for disloyal consumers is higher than the price that would likely be set absent the rebate scheme. This could suggest the firm is confident that the strategy will raise rivals' costs (or tax their prices) and thereby support higher prices.

ENDNOTES

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- ¹ The terminology can include loyalty discounts, exclusivity rebates, market share rebates, target rebates, share of need discounts, and quantity rebates, volume discounts.
- ² However, the use of a term that is based on the effect, rather than the nature, of the rebate is unhelpful, for example, a rebate based on purchasing 100 per cent of the buyers requirements might not succeed in generating exclusivity if the incentive is marginal or if the buyer decides against acting on the incentive. Equally, a scheme with larger deductions but based on lower thresholds might persuade a buyer to exclusively deal with the seller.
- ³ These are sometimes referred to as retrospective, all-unit, or roll-back rebate schemes.
- ⁴ Scott-Morten (2013)
- ⁵ If a seller can accurately predict that a buyer's demand will be 100 this year, then a target quantity rebate that rewards sales above a target of 80 units is in practice the same as a share of need rebate that rewards the firm for purchasing more than 80% of its requirements.
- ⁶: Case COMP/E-1/38.113 – Prokent-Tomra, 29 March 2006
http://ec.europa.eu/competition/antitrust/cases/dec_docs/38113/38113_250_8.pdf
- ⁷ Ibidem, par. 412.
- ⁸ Case T-155/06 - *Tomra Systems ASA and Others v European Commission*, Judgment of the General Court (Fifth Chamber) of 9 September 2010. <http://curia.europa.eu/juris/liste.jsf?language=en&num=T-155/06>
- ⁹ Case C-549/10 P - *Tomra Systems ASA and Others v European Commission*, Judgment of the Court (Third Chamber) of 19 April 2012. <http://curia.europa.eu/juris/liste.jsf?language=en&num=C-549/10%20P>
- ¹⁰ See for example the concerns from Justice Greenberg and 18 scholars (see footnote 66) on the potential price chilling effects of action against fidelity rebates. The concerns lead these authors to conclude that defining a safe-harbour is necessary to prevent these effects. It is worth noting however, that investigations into exclusive dealing agreements have not prevented these agreements becoming ubiquitous. Moreover it is unclear how a firm that is discouraged from competing using fidelity rebates would react, for example whether it would compete using incremental rebates instead or decide not to compete at all.
- ¹¹ See discussion in Geradin and Petit (2005) and in Papandropoulos (2007).
- ¹² For example, share of need rebates may help to guarantee that a certain minimum volume of sales are made and this may enable planning decisions that reduce costs to be taken (See Crane 2013c).
- ¹³ If both upstream and downstream sellers have market power then each will be able to raise their price above cost, the combined effect of taking these two margins is that the retail price is set too high (above that which would be optimal for a vertically integrated firm). One way to remove this problem is vertical integration, however an alternative is for the upstream firm to engineer a more competitive downstream market that removes the ability of downstream firms to raise retail price above wholesale price.
- ¹⁴ Crane (2013c)
- ¹⁵ This might also be labelled “partial foreclosure”; however, we use this more descriptive formulation.

16 See European Commission (2009).

17 See OECD (2004)

18 United States Supreme Court, *Brooke Group Ltd v. Brown & Williamson*, Nos. 92-466, 21 June 1993
<https://www.law.cornell.edu/supct/html/92-466.ZO.html>

19 Rasmusen (1991), Bernheim and Whinston (1998), and Segal and Whinston (2000)

20 See Asker and Bar-Isaac (2014); DeGraba (2013); and DeGraba and Simpson (2014)

21 Note however that equally, a collusive strategy might be used to foreclose access to customers and a divide and rule strategy might be used to foreclose access to key inputs.

22 *United States v. Dentsply Int'l, Inc.*, 399 F.3d 181, 19193 (3d Cir. 2005). This was described in chapter 8 of the withdrawn DOJ/FTC guidance on single firm conduct (US DOJ, 2008) as follows: “The Third Circuit held in 2005 that Dentsply's practice of refusing to sell to distributors that carried other manufacturers' artificial teeth violated section 2 because it unlawfully maintained Dentsply's monopoly power. This practice left Dentsply's rivals with distribution methods entailing "significantly higher transaction costs, extension of credit burdens, and credit risks," thereby "keep[ing] sales of competing teeth below the critical level necessary for any rival to pose a real threat to Dentsply's market share." Finding that Dentsply's policy "exclude[d] its rivals from access to dealers," the court held that Dentsply's proffered efficiency justifications were "pretextual" and "did not excuse its exclusionary practices." Notably, the *Dentsply* court distinguished several other courts' assertions that short-term exclusive-dealing contracts are presumptively legal, explaining that a policy of not dealing with customers also patronising a rival can "realistically make the arrangements . . . as effective as those in written contracts."

23 Case T-65/98, *Van den Bergh Foods Ltd v. Commission*, [2003] ECR II-4653. In which the European Court of First Instance held that an exclusivity clause restricting ice-cream retailers' use of freezers supplied by Van den Bergh Foods in Ireland infringed EC competition law.

24 Bundeskartellamt (2015) “Bundeskartellamt Opens Proceedings Against Audible/Amazon And Apple”16 November:http://www.bundeskartellamt.de/shareddocs/meldung/en/pressemitteilungen/2015/16_11_2015_audible.html

25 See European Commission (2009), para 37. De facto exclusive dealing is sometimes referred to as a fidelity rebate that is “loyalty inducing”, however this terminology risks confusing matters since a wide range of competitive tools might be inducements to stay loyal. In this sense, de facto exclusive dealing is more meaningful since it describes a state rather than a purpose.

26 As cited in Salop (2013a).

27 Calzolari and Denicolo (2013) also provide a model in which firms producing differentiated products compete with incomplete information about demand. They identify that share of need rebates lead to higher prices than are found when the firms can agree exclusive agreements. This is because these rebates allow firms to tax one another's product.

28 The analysis notes: “In a market such as this one, where the most realistic mode of competition by competitors to a monopolist involves their selling initially modest quantities to direct buyers who also buy large quantities from the monopolist, such conditioning can amount to a tax on the growth of such competition, and can enable the monopolist to sustain high prices at the same time as it limits competition and decreases consumer choice.” FTC, 9341, *Intel Corporation; Analysis of Proposed Consent Order to Aid Public* Comment

29 Farrell, Pappalardo and Shelanski (2010)

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- 30 Inderst and Shaffer (2010)
- 31 Peeperkorn (2014), page 58, on Salinger (2014).
- 32 Elhauge and Wickelgren (2015)
- 33 See for example: Blair and Sokol (2012), Wright and Ginsberg (2013), and Kirkwood and Lande (2008); Akman (2009); Odudu (2010); Zimmer (2012)
- 34 Farrell & Katz (2006)
- 35 Mariniello, Neven and Padilla (2015)
- 36 See for example Bork (1978), Heyer (2006). Note however that adoption of an aggregate welfare standard would not require that firms engage in conduct that maximises aggregate welfare. Instead, it would simply prohibit conduct by firms that reduced aggregate welfare. Salop (2010), Farrell & Katz (2006).
- 37 Wils (2014)
- 38 Rey and Venit (2015) describe ordo-liberalism as a philosophy that places value on the protection of ‘individual freedom as an end in itself’. They cite Möschel (1989) as identifying that one of the four pillars of ordo-liberalism is ‘the shaping of competition policy into a rule of law rather than a mechanism of discretionary decision.’ (p. 142). Möschel further notes that ‘The actual goal of the competition policy of Ordo-liberalism lies in the protection of individual economic freedom of action as a value in itself, or vice versa, in the restraint of undue economic power.’
- 39 See Ahlborn & Piccinin (2015) and Petit (2015a), page 28: “there is no strong economic and legal support to the proposition that the competitive process is the lynchpin of Article 102 TFEU. In particular, neither the language nor the spirit of the Treaty provide clear backing to this argument.”
- 40: Case COMP/C-3/37.990 — Intel, [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0922\(02\)&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0922(02)&from=EN)
- 41 Ibidem, par. 924
- 42 Ibidem, par. 925
- 43 Ibidem, par. 1574-5
- 44 Case T-286/09 - *Intel Corp. v European Commission*, Judgment of the General Court (Seventh Chamber, extended composition) of 12 June 2014. <http://curia.europa.eu/juris/liste.jsf?num=T-286/09>
- 45 This can be difficult though in practice the frequency with which both effects arise might be limited.
- 46 See Salop (2006), and CJEU on Post-Danmark II (see footnote 77)
- 47 Adam & Maier-Rigaud (2008) also note that this standard would effectively amount to a paternalistic assumption that consumers are wrongly buying from less efficient competitors and that dominant firms therefore need to be called in to restore market efficiency.
- 48 Communication from the Commission — *Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings*, OJ C 45, 24.2.2009, p. 7–20. [http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52009XC0224\(01\)](http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52009XC0224(01))

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- 49 Note that in contrast to the suggestion in paragraph 61 this uses the costs of the dominant firm rather than those of the rival.
- 50 OECD (2005)
- 51 Vickers (2004). Also Edlin & Farrell (2003): “‘Sacrifice’ – behavior that would be irrational without its exclusionary effect – is logically neither necessary nor sufficient for harm to competition. It could yet be a useful test, but only because of some (still unexplored) empirical correlation, not as a matter of economic logic.”
- 52 OECD (2005)
- 53 Geradin (2015) p21 gives this interpretation to the GCEU judgment on Intel and criticises it as unjustified.
- 54 Whish (2015) argues that exclusivity agreements do not have as their ‘object’ the restriction of competition for the purposes of Article 101, and cites *Delimitis v Henninger Brau* to suggest that the court agrees.
- 55 Heimler (2005) suggests that the EU Courts’ approach to fidelity rebates is akin to “banning the sale of Ferrari cars, because it is highly probable that drivers will not respect the speed limits.” The suggestion being that the use of fidelity rebates by firms with market power is not automatically anticompetitive, but that an anticompetitive outcome is sufficiently likely as to merit treating them as per se harmful, rather than investigation whether harm is likely in each case.
- 56 Whish (2015, p.2): “Is a formal rule that reverses the evidential burden of proof in a case where a firm dominates a market perverse? If one firm has the ability to act ‘independently of its competitors, customers and ultimately of its consumers’ (United Brands) the state of competition in that market can hardly be healthy, to say the least. It is not clear why it should be regarded as wrong in principle— or divorced from economics—to apply a stricter standard to exclusivity where a firm is dominant or, as I would prefer to say, has substantial market power.”
- 57 See De la Mano at the US FTC/DOJ (2014) workshop, and Wils (2014).
- 58 United States District Court, District of New Jersey, *Civil Action No. 08-4168 (MLC)*, 28 March 2014: http://res.cloudinary.com/lbresearch/image/upload/v1396896076/Eisai_v_Sanofi_3_28_Opinion_Unsealed_nbzekj.pdf
- 59 See OECD (2004). Agencies tend to use a price-cost test to understand whether the alleged predator is genuinely sacrificing profit or whether it is able to set lower prices simply because it is more efficient. The most often used measures of cost are marginal cost, average variable cost, average avoidable cost, long run average incremental cost, and average total cost.
- 60 De la Mano and Durand (2005, p.3): “Predation involves an action that entails a profit sacrifice relative to some more profitable alternative but for the elimination or disciplining of rivals and the subsequent increase in market power. Thus, a rational profit-maximising firm would never predate except if such conduct is (i) likely to exclude or discipline aggressive and (ii) the predator will be able to exercise increase market power and thus recoup its initial profit sacrifice, for example by raising prices beyond pre-predation levels. Proof of predation involves showing that predatory conduct is economically rational and has taken place. To this effect, we advocate a three-step structured rule of reason. A competition authority adopting our approach would bring a predation case if there is convincing evidence that: 1. The defendant has sacrificed profits. 2. As a result, one or more rivals have or likely will be excluded from competing with the alleged predator in some market. 3. Once rivals are excluded, the alleged predator can exercise increased market power and thereby recoup the initial sacrifice.”
- 61 Crane (2013b) notes that, “If an incumbent firm with marginal costs of \$50 and a current price of \$100 faces entry by a new rival with marginal costs of \$75 and drops its price to \$74 in order to exclude the new

rival, it enjoys categorical immunity under a long line of Supreme Court cases.” The court in its Brooke Group finding, said that above-cost pricing “either reflects the lower cost structure of the alleged predator or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting.” Pollina (2013) suggests, “It is quite clear that the Court understood that above-cost pricing can still be anticompetitive, and that it opted for an above-cost safe harbour based on concerns for false positives and institutional competence. The Court did not abandon the notion that above-cost pricing schemes can be exclusionary and anticompetitive.”

62 Albaek, S. & Claici, A. (2009)

63 This draws on analytical steps in foreclosure analysis articulated in ICN (2013b), Salop (2013a), Gavil in ICN (2013a), Wright (2012 and 2013) and Gates (2013).

64 Notably in ZF Meritor/Eaton the court found that partial exclusivity was sufficient.

65 Gates (2013) p.134, identifies that “customers may prefer the defendant’s products for all sorts of reasons other than the rebates, such as superior quality, service, or reliability. The plaintiff must show that the defendant’s rebate scheme, and not other factors, caused the foreclosure.”

66 Note that share of need thresholds that deliver partial exclusivity can still be harmful, for example if minimum efficient scale is particularly high.

67 United States Court of Appeals for The Third Circuit, *ZF Meritor LLC and Meritor Transmission Corporation v. Eaton Corporation*, Nos. 11-3301 and 11-3426, 26 June 2012 <http://www2.ca3.uscourts.gov/opinarch/113301p.pdf>

68 Brief for eighteen scholars as *amici curiae* in support of petitioner (2013)

69 Ibidem, page 4.

70 See US FTC/DOJ (2014). Summary reports (O’Melveny & Myers 2014) suggested that: “most panelists urged the DOJ and FTC to reject the price-cost test. They described the test as inaccurate and poorly-suited for exclusionary loyalty discounts, which are far easier to execute than a predatory pricing scheme. A number of economists also faulted the price-cost test’s lack of predictability and administrability—its supposed main selling point—because there is no consensus on the appropriate measure of cost or the method for allocating discounts among the purchased products. Notably, in the workshop’s only session with a single speaker, Professor Steven Salop of Georgetown University Law Center detailed the drawbacks of the price-cost test and advocated for an alternative test that examines whether loyalty discounts raise rivals’ costs. And at the final session of the day, American University Washington College of Law Professor Jonathan Baker summarised the workshop’s “big takeaway” as “price-cost tests . . . [are] really not helpful.” See also Wright (2013), Gates (2013), and American Antitrust Institute (2014).

71 Salop (2013a), Gavil in ICN (2013a), Wright (2012)

72 Fumagalli and Motta (2015) suggest that this requires “an analysis of the fragmentation of the demand side of the market, and in particular of whether lack of access to some critical buyers may impair the rival’s ability to compete and why; and an understanding of whether scale economies are prevalent.”

73 Wright (2013), Majumdar (2014)

74 See Farrell’s contribution to US FTC/DOJ (2014) workshop on conditional pricing practices. Abito & Wright (2008) also show this is equilibrium if downstream competition is sufficiently strong or if upstream sellers use two-part tariffs. The intuition is that in these situations the profit of downstream sellers shrinks to almost nothing. It is therefore easy for an upstream incumbent to offer them small shares of the profit that is created by excluding its upstream rivals.

75 See note 16

76 See *Guidance on the Commission's enforcement priorities* (2009) and UK OFT (2005).

77 Neven (2015) suggests it is not a necessary condition but suggests instead that the test might shift the presumption. Peeperkorn (2014) suggests that the test fit the facts of the Intel case (see box 2). Fumagalli and Motta (2015) suggest it is helpful in forcing us to understand why an apparent ability to match a rebate scheme is not enough to allow a rival to compete.

78 Case C-23/14, *Post Danmark A/S v Konkurrencerådet* ('*Post Danmark II*'), preliminary ruling by the Court of Justice of the European Union, 6 October 2015 <http://curia.europa.eu/juris/liste.jsf?num=C-23/14>

79 *Post Danmark II judgement*, Par.13

80 *Ibidem*, Par. 28

81 *Ibidem*, Par.62

82 *Ibidem*, Par.52

83 KFTC Decision No. 2009-281

84 Fumagalli and Motta (2015) p21: “the exclusionary potential of loyalty rebates may call for a stricter treatment by antitrust agencies. This may justify denying an above-cost pricing safe harbour for loyalty.”

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