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Executive Summary of the Roundtable on Fidelity Rebates held at the 125th meeting of the Competition Committee of the OECD

15-17 June 2016
Paris, France

This Executive Summary by the OECD Secretariat contains the key findings from the discussion held under Item 6 of the 125th Meeting of the Competition Committee on 15-17 June 2016.

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

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Executive Summary of the Roundtable on Fidelity Rebates held at the 125th meeting of the Competition Committee of the OECD

By the Secretariat[1]

From the discussion at the hearing, the delegates' and experts' written submissions, several key points emerged:

1. Fidelity rebates or loyalty discount schemes are widely used and are often beneficial for consumers. Rebates based on quantity, and in some cases even those based on exclusivity, can potentially generate a number of efficiencies. They may pass economies of scale onto consumers. Alternatively, they can give distributors an incentive to increase their effort to sell the firm's product. They can also be used to price discriminate, in which case they may increase competition and expand output. In addition, they might be used to stimulate downstream competition.

Firms use fidelity rebates or loyalty discount schemes to offer better prices to buyers that demonstrate loyalty in the purchases they make. They are often introduced as discounts on an existing price, rather than as increased penalty price for disloyal buyers. They can include exclusivity rebates that depend on the buyer purchasing exclusively. However, they can also involve a discount on further purchases once a buyer makes a certain quantity of purchases.

Where the loyalty demonstrated by the purchaser generates economies of scale then a scheme that passes these savings onto the customer brings price closer to marginal cost. In intermediate markets, fidelity rebates can also help to resolve a problem of moral hazard by better aligning the incentives of the distributor with those of the producer, who cannot observe the distributer's actions. This can provide a producer with confidence that its rival producers will not free ride on any investments that it makes in selling through a given distributor.

Rebates that are conditional on loyalty may help firms to price discriminate between buyers that are willing to pay different prices. This price discrimination can in some cases increase output and/or competition. For example, exclusivity rebates might enable a firm to distinguish and discriminate between customers that have relatively high and low preference for their product. In particular, exclusivity rebate schemes might be more effective than quantity-based discount schemes if total demand is unpredictable.

A seller might also decide to use an exclusivity rebate to stimulate competition between its smaller and larger downstream purchasers. For example, increased competition in downstream markets might help it to reduce double marginalisation on its product. There remains a question over whether these different types of benefit might be achieved through less anticompetitive means, and so not qualify as relevant efficiencies. However, this will depend on the facts.

2. In some cases however, a dominant firm's use of fidelity rebates can harm consumers by reducing the ability of rivals to compete effectively. This is because fidelity rebates, and particularly exclusivity rebates, can be used to ensure that competition is for the customer itself, rather than for units purchased by the customer. This shift in the level of competition can in some cases exclude rivals if there is an asymmetry in the dominant firms' ability to compete at this new level. Asymmetries might include the ability to raise rivals' costs, either by denying rivals economies of scale, or access to key inputs. They might also include a willingness and ability to coordinate with firms in a competitive downstream market.

[1] This Executive Summary does not necessarily represent the consensus view of the Competition Committee. It does, however, encapsulate key points from the discussion at the roundtable, the delegates' written submissions, the panellists' presentations and the Secretariat's background note.

Fidelity rebate schemes that are effective in persuading customers to purchase exclusively can be treated as *de facto* exclusive dealing arrangements. In the same way that exclusive dealing by a dominant firm can, but does not always, exclude rivals, de facto exclusive dealing can do the same. The concern is that a dominant firm might use the scheme to move away from competing for sales of units of the good, and towards competing for consumers (supplying all the consumer's needs). This move is not in itself a problem; however, it can become a problem if the move allows the dominant firm to take advantage of an asymmetry that it did not enjoy when competing for units. This can lead to the competition for customers being less intense than the competition for units was.

To distinguish between those schemes that benefit consumers and those that abuse market power and harm consumers, competition agencies therefore need to understand why it is that a rival might not be able to match the scheme and compete for the customer rather than for the unit. There are a number of possible sources of asymmetry.

One is that the dominant firm might be able to sacrifice profits, either in the short term, or on 'non-contestable' sales, where a rival cannot afford to do so. However there a number of other source of asymmetry that do not require profit sacrifice.

Where there are economies of scale the asymmetry might come from the dominant firm's ability to prevent its rivals from making enough sales to obtain those economies of scale. If rival's fixed costs are spread across a smaller quantity of sales then their average costs will increase and they may struggle to cover their fixed costs. A dominant firm might prevent rivals from making sales by making buyers fear that a lack of coordination will leave them purchasing from a seller without efficient scale. It might induce a lack of coordination amongst buyers by offering individualised rebates, at different times, and without making information available (a divide and conquer strategy).

In other cases, instead of denying rivals access to consumers, the dominant firm might be able to deny rivals access to key inputs and hence increase their costs. For example, the key inputs required for efficient production might include raw materials, intellectual property, or an effective distribution network.

A further source of asymmetry might be that the dominant firm is willing and able to coordinate with downstream firms to increase the retail price of its product, while the rival is not. This coordination would need to split the increase in profits with the downstream firms so that they do react to this price increase by switching to selling a rival product. It may not always be possible to reach agreement on a division of the increased profit; however, in certain circumstances a sustainable agreement seems likely to be possible.

In the absence of evidence of some asymmetry, a move from competition for units, to competition for customers, will not increase or protect the dominant firm's market power. As such identifying that a fidelity rebate scheme has 'loyalty inducing' effects is, on its own, not sufficient to show an abuse of dominance. Whenever competition agencies take action against a fidelity rebate scheme, they should therefore be able to demonstrate not only that the scheme has 'loyalty-inducing' effects which create exclusive relationships, but also explain, with evidence, why rivals are unable to effectively compete for that exclusivity.

3. Tests for below-cost pricing, including the 'discount attribution test', are not a reliable way to identify the anticompetitive effects of a fidelity rebate scheme. A predatory pricing framework can identify cases in which firms use a fidelity rebate scheme to put in place a strategy of predatory foreclosure against an as-efficient competitor. However, it fails to identify cases in which consumers are harmed as a result of a firm excluding rivals without pricing below cost. While a price-cost test might be a useful analytical tool in some cases, it would be ineffective as a screening device or safe-harbour in an assessment or prioritisation guide.

Where the allegation is that price is below cost, once the effect of rebates is included, the standard analytical framework for predatory pricing can be used. Similarly, there may be a concern that a dominant firm uses fidelity rebates to set an effective price for 'contestable' units that is below cost, in order to exclude an as-efficient competitor. In that case, a modified price cost test (the 'discount attribution' test) can be used. However, it is not clear what basis should be used to define and identify these 'non-contestable' units.

However, neither of these tests identifies schemes in which a firm forecloses rivals without sacrificing profits. A firm might foreclose an equally efficient rival without sacrificing profit by taking advantage of the potential asymmetries outlined above. Alternatively, it might foreclose a less efficient rival, which would not require a sacrifice of profit. For example, allowing a dominant firm to increase the costs of a less efficient rival can harm consumers if it weakens further the competitive constraints upon the dominant firm. Moreover, future consumers may benefit if firms with market power are prevented from foreclosing less efficient rivals that - if they survive long enough - might become equally or more efficient. Concerns that a dominant firms should not be asked to hold a 'price umbrella' over less efficient firms (to keep them viable) do not apply to fidelity rebates as they would in predatory pricing cases. This is because the option to undercut through a simple unit price reduction rather than a fidelity rebate is always available.

Relying on a price-cost test to prioritise or screen cases is likely to result in the misdirection of resources towards predatory cases and away from cases in which exploitatively high prices are set and protected through fidelity rebates. These high price exclusionary strategies are likely to be less risky (since there is no loss-making period), and hence more attractive to dominant firms, as well as more immediately harmful to consumers. A more effective screen would therefore be one that prioritised the investigation of cases in which high prices are insulated at the expense of predatory cases.

4. In recent years there have been some encouraging signs of movement towards a more effects-based approach to fidelity rebate cases. This is evident for example, in a narrowing of the scope for a presumption that fidelity rebates have anticompetitive effects, as well as a rejection of the presumption that rebates in which the effective price is above cost do not have anticompetitive effects. However, in other cases there remain considerable differences in approach.

Competition agencies are increasingly identifying that fidelity rebates can have ambiguous effects on consumers and are therefore analysing the effects of allegedly harmful fidelity rebates rather than simply assuming that they are harmful. For example the European Commission's prioritisation guidance signalled its adoption of an effects-based approach to fidelity rebates and this has been reflected in the prioritisation decisions that it has taken since then. The European Courts have also narrowed their use of anticompetitive presumptions in abuse of dominance cases. Similarly, other jurisdictions are applying effects-based analysis in this area.

Equally, there has been movement away from a proposal that where the effective price remains above cost, fidelity rebates can be presumed to be pro-competitive. For example, some courts in the US, Europe and in other OECD jurisdictions have rejected arguments that a price cost test is a necessary condition for consumer harm. Instead, they have examined the effects of these fidelity rebates as de facto exclusive dealing arrangements.

Any cautious optimism over the building of a degree of consensus on the approach to fidelity rebates must however be tempered by the continued support in some quarters for a strict *per se* prohibition despite the lack of an economic basis for such a position.