JUNE 2008, RELEASE ONE

GCP
THE ONLINE MAGAZINE FOR GLOBAL COMPETITION POLICY

Anticompetitive Rebates in EC Competition Law: A Way Forward?

Renato Nazzini

University of Southampton

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

Anticompetitive Rebates in EC Competition Law:

A Way Forward?

Renato Nazzini[*]

One area of EC competition law that has been particularly controversial in recent years is the application of Article 82 of the EC Treaty to allegedly anticompetitive rebates. The case law of the Community Courts concerns single-product rebates, but even more complex issues arise if the rebate is given on condition that the customer buys certain amounts of a number of products (two or more) offered by the dominant undertaking.[1] These rebates may be analyzed as a mixed bundle but also as a rebate whose foreclosure effect may be functionally equivalent to that of single-product rebates. This is because, similar to single-product rebates, multi-product rebates may have the effect of denying single-product competitors the opportunity to reach the minimum efficient scale in their respective markets.

The reason for the controversy is relatively clear. Rebates are essentially discounts. Discounts generally result in lower prices and larger output, which is precisely one of the parameters of competition that the law aims, or should aim, at encouraging. Furthermore, the rebates in question result on average prices on the overall output of the dominant undertaking that are above the measure of cost that would be used in predatory

[*] The author is Reader in law, University of Southampton and Solicitor, England and Wales.

[1] *See* LePage's Inc. v. 3M, 324 F.3d 141 (3d Cir. 2003) (en banc) (concerning rebates conditioned on purchases spanning six of 3M's product lines and with the size of the rebate linked to the number of product lines in which the sales target was met).

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

pricing analysis. In light of these considerations, it may be argued that rebates should always be legal and never prohibited. It could even be argued that rebates are less likely to be harmful than predatory pricing because an above-cost discount would appear to be simply a low price that a competitor should be able to match unless it is less efficient than the dominant undertaking. And competition law should not protect less efficient rivals.

The reality is, however, that predatory pricing is a less plausible exclusionary strategy than rebates. The reason is, intuitively, that predatory pricing is a risky strategy unless recoupment is reasonably probable. The probability of recoupment presupposes market conditions not frequently observable, such as high and durable barriers to entry or expansion, which ensure that entry or expansion is unlikely to occur again during the recoupment period. Rebates, on the other hand, are an exclusionary strategy that does not necessarily entail a profit sacrifice. Therefore, they can be sustained for a long time, or even indefinitely, denying rivals the opportunity to achieve a minimum efficient scale in markets characterized by economies of scale or network effects. Such an exclusionary effect may be particularly harmful in markets characterized by substantial research and development (R&D) costs and innovation. On these markets, denying rivals the opportunity to reach the minimum efficient scale needed to recoup R&D costs could discourage innovation in the medium and long term. Yet, the analysis of the anticompetitive effects of above-cost discounts is complex and the consequences of false positive errors and over-deterrence potentially serious. False positive errors and over-deterrence with respect to above-cost discounts may not only result in higher prices and

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

lower innovation, but could affect a much wider range of pro-competitive conduct than false positive errors and over-deterrence with respect to predatory pricing.

This article is organized as follows:

- **Section I** discusses the EC case law and the risks of false positive errors and over-deterrence it gives rise to;
- **Section II** analyzes the approach suggested in DG Competition discussion paper ("Discussion Paper")[2] on the application of Article 82 of the Treaty to exclusionary abuses, published in December 2005;
- **Section III** proposes a principle-based analytical framework as a possible way forward for the assessment of anticompetitive rebates. Under the proposed analytical framework, dominant undertakings benefit from meaningful safe harbors and anticompetitive rebates are assessed based on a medium- to long-term consumer harm test; and
- **Section IV** draws a general conclusion.

I. THE EC CASE LAW

The EC case law has taken a restrictive approach to rebates. The European Court of Justice (ECJ) held that an undertaking in a dominant position infringes Article 82 if it ties purchasers by an obligation or promise on their part to obtain all or most of their requirements exclusively from itself. It is also an abuse to achieve the same result through discounts conditional on the customer purchasing all or most of its requirements from the undertaking in a dominant position.[3] Furthermore, for an abuse to be established, it is not necessary that a customer must be either required or induced to purchase all or most of the requirements from the dominant undertaking. It is sufficient

[2] *See* EUROPEAN COMMISSION, DG COMPETITION DISCUSSION PAPER ON THE APPLICATION OF ARTICLE 82 OF THE TREATY TO EXCLUSIONARY ABUSES (Dec. 2005) [hereinafter "Discussion Paper"].

[3] Case 85/76, Hoffmann-La Roche v. Commission, 1979 E.C.R. 461, at para. 241.

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

that the rebate is capable of having an exclusionary effect by making entry very difficult or impossible and by making it more difficult or impossible for customers to choose between different suppliers.[4] However, it is always possible for the dominant undertaking to "demonstrate" that the exclusionary effect is economically justified.[5]

The principles established in the case law may not in themselves be excessively problematic. In particular, if the capability of the rebate system to have an exclusionary effect is properly defined, it may be reasonable to presume that such a foreclosure effect causes medium- to long-term consumer harm and is inefficient. In these circumstances, it may be sensible to require the dominant undertaking to show that there are countervailing factors that outweigh the prima facie case of abuse, one example being economies of scale (e.g., if there is a cost of $100 per shipment to deliver the product in question and up to 100 units may be delivered by any one shipment, then it would be justified to provide the customer with incentives to buy up to 100 units by granting a discount equal to the reduction in average cost that results from the delivery of the additional units). What is problematic in the EC case law is that the application of the legal principles to the facts of the individual cases suggests that the elements of the abuse will be readily established. Thus, in *British Airways*, the ECJ considered the following factors to be relevant:

a) the commission scheme related to individualized targets;

b) the commission was retroactive, with the consequence that the sale of a marginal unit had a very strong effect on the rate of commission; and

[4] Case C-95/04, British Airways v. Commission, 2007 E.C.R. I-2331, at para. 68.

[5] *Id.* at para 69.

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

c) British Airways' market share was considerably larger than the market shares of its competitors, suggesting that the latter could not replicate the commission scheme of the dominant undertaking.

In *Michelin II*,[6] the European Court of First Instance (CFI) held that a rebate scheme based on a pre-determined grid, in which the rate of discount increased according to the turnover achieved with Michelin, was abusive. The Court said that a quantity rebate system in which there is a significant variation in the discount rates between the lower and higher steps, which has a reference period of one year, and in which the discount is fixed on the basis of total turnover achieved during the reference period, has the characteristics of a loyalty-inducing discount system.[7] Such a loyalty-inducing discount system is abusive unless it is based on a countervailing advantage which may be economically justified.[8] Both *British Airways* and *Michelin II* recognize that a prima facie abusive rebate system may be objectively justified, but the Community Courts' decisions may be read as suggesting that an objective justification is unlikely to be upheld.

Notwithstanding the potential for anticompetitive effects, a per se prohibition of certain forms of rebate (e.g., retroactive or individualized rebates) by a dominant undertaking is not desirable. There is no empirical evidence or economic theory suggesting with any degree of confidence that a rebate with certain formal characteristics has anticompetitive effects and no redeeming virtue. On the other hand, a retreat from enforcement activity in this area is equally undesirable and is certainly not the option

[6] Case T-203/01, Manufacture française des pneumatiques Michelin v. Commission, 2003 E.C.R. II-4071 [hereinafter *Michelin II*].

[7] *Id.* at para. 95.

[8] *Id.* at para. 98.

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

preferred by the European Commission, which is pursuing investigations in this area.[9] The current case law, however, while not adopting a per se rule, appears to favor an abridged rule of reason approach that does not necessarily focus on the most relevant factors in the assessment of anticompetitive effects and may give rise to an undesirably high risk of false positive errors and over-deterrence.

II. THE DISCUSSION PAPER

The Discussion Paper provides a valuable analytical framework for analyzing the anticompetitive effects of rebates. The methodology suggested by DG Competition is based on the intuition that a dominant undertaking may face a demand curve with an inelastic segment (assured base) and an elastic one (contestable share of demand). Obviously, things are more complicated because the inelastic and the elastic parts of the demand are often a continuum. However, adopting for simplicity the basic model, the theory of harm is based on the idea that the dominant undertaking may have the ability and the incentive of setting a rebate scheme that provides customers with strong incentives to purchase additional units of the product above the assured base. If this is the case, the rebate is capable of having a foreclosure effect if the effective price calculated by allocating the entire discount to the contestable share of the dominant undertaking's output is lower than an appropriate measure of cost (the Discussion Paper adopts average total cost as the benchmark). If, as a result, competitors are denied the benefit of

[9] For instance, in July 2007, the Commission addressed a statement of objections to Intel alleging that Intel had engaged in three types of abuse of a dominant market position, including providing substantial rebates to various original equipment manufacturers (OEMs) conditional on them obtaining all or the great majority of their computer processing unit (CPU) requirements from Intel. *See* European Commission, MEMO/07/314, Competition: Commission confirms sending of Statement of Objections to Intel (Jul. 27, 2007), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/07/314.

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

economies of scale, the rebate may have a foreclosure effect. It is then open to the dominant undertaking to demonstrate that the rebate is objectively justified.

It can be argued that the Discussion Paper analyzes rebate systems applying a modified predation analysis in which the predatory price is charged on the contestable amount of the output. However, this theory of harm is probably better explained as a strategy that raises rivals' costs. While this intuition is fundamentally correct, the approach set out in the Discussion Paper is probably still too complex and excessively rigid. Furthermore, it may still fail to strike the right balance between the risk of false positive and false negative errors and between over-deterrence and under-deterrence. Finally, it may not provide dominant undertakings with a sufficient degree of legal certainty in setting their pricing strategies.

III. A WAY FORWARD

In order to devise a workable analytical framework for assessing exclusionary conduct, it has been suggested that it is appropriate to take into account the probability of the exclusionary conduct occurring and causing substantial harm to consumer welfare, the benefits of competition law enforcement, and the deterrent effect of false positive errors.[10] Rather than to devise prohibition rules, such an approach may be adopted to set out safe harbors that take into account the beneficial and harmful effect of particular types of conduct and the risks of erroneous intervention. Safe harbors could provide a significant degree of certainty to undertakings and may act as a filter for competition cases.

[10] M. Lao, *Defining Exclusionary Conduct Under Section 2: the Case for Non-Universal Standards*, in 2006 FORDHAM CORP. L. INST.: INT'L ANTITRUST L. & POL'Y 433, 434 (B. Hawk ed., 2007).

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

Some safe harbors, however, may be more illusory than real. For instance, it could be argued that if competitors can compete for all the sales made by the dominant undertaking, then the rebate should be presumed lawful unless it is predatory. It is also sometimes argued that if competition between the dominant undertaking and the other suppliers is symmetric because all suppliers have comparable assured bases of sales, then the rebate should not be held capable of having an exclusionary effect. While they are undoubtedly correct, these safe harbors are of little avail in abuse of dominance cases. By definition, in an abuse of dominance case the market will be characterized by economies of scale, network effects, or capacity constraints of rivals. Therefore, in such cases, competitors will never be able to compete across the board with the dominant undertaking nor will they have a comparable assured base. If the contrary is true, then the undertaking under investigation (or the defendant) is most likely not dominant. The question is then: what safe harbors can be devised based on the probability of the conduct being harmful and the risks of false positive errors in order to give dominant undertakings a meaningful degree of legal certainty?

A first safe harbor could be framed a "presumption" that if less than 50 percent of the market is tied by the allegedly foreclosing practices (not necessarily by rebates only as rebates may be combined with exclusive contracts or other functionally equivalent arrangements), there is no abuse unless the allegedly foreclosing practices are targeted at the only segment of the market that is open to entry or at a segment of the market that is necessary for successful entry to occur. This safe harbor is based on the idea that if 50

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

percent of the market is not tied, then competitors are likely to be able to compete for at least 50 percent of the demand. As a consequence, the allegedly foreclosing practices are unlikely to have the effect of denying rivals the opportunity of reaching their minimum efficient scale as the minimum efficient scale cannot be more than 50 percent unless the market is a natural monopoly.[11]

This safe harbor based on the tied share on the market may be under-inclusive and, as a consequence, some harmful behavior will fall within the safe harbor and will not be captured by the Article 82 prohibition. However, the risk of significant competitive harm occurring or being undeterred is probably low because, if at least 50 percent of the market is not tied and fully contestable, normally equally efficient or more efficient rivals would be able to compete and grow.

The cases where anticompetitive harm is most likely to occur within the safe harbor are instances in which the remaining 50 percent of the market is not fully contestable because of foreclosing arrangements between other suppliers and their customers. If the dominant undertaking A ties 45 percent of the market and another undertaking B ties 40 percent of the market, then the share of the market which is foreclosed is 85 percent. If the minimum efficient scale of an equally efficient competitor C is 20 percent, then the dominant undertaking’s rebate scheme may have a foreclosure effect. Furthermore, the foreclosure effect in question is likely to be harmful because it may protect a duopoly which is less efficient than a more competitive counterfactual in which undertaking C is not foreclosed. One way of addressing this problem may be to

[11] For a similar analysis, but in a different context and leading to a different conclusion, *see* E. Elhauge, *Defining Better Monopolization Standards*, 56 STANFORD L. REV. 253, 323-27 (2003).

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

provide that the safe harbor only applies if the tied share of the market is less than 50 percent, regardless of whether it is foreclosed by the dominant undertaking or also by other undertakings. Alternatively, and perhaps more appropriately, it is always possible to pursue the case under Article 81 of the EC Treaty, which prohibits anticompetitive agreements and concerted practices, including vertical agreements. Under Article 81, the effects of a network of vertical agreements may be assessed.[12]

Another case in which the safe harbor in question might be under-inclusive is when the need to recoup substantial investment in R&D requires that competition for the entire market is non-foreclosed. Even little foreclosure may have the effect that investment in R&D is sub-optimal.[13] This scenario is plausible when foreclosure is in the form of exclusive contracts because the legal obligation of customers not to purchase from any other supplier means that the innovator will not be able to have access to the foreclosed share of the market no matter how desirable its product or how low its price. However, if it is a rebate system that causes the alleged foreclosure effect, provided that the innovator has non-foreclosed access to at least 50 percent of the market, once it has gained a significant share of demand (up to 50 percent), it will generally be able to compete with the dominant undertaking on price and quality for the remaining share. Therefore, a further exception to the safe harbor to cater to circumstances in which the need to recoup substantial investment in R&D requires that there be non-foreclosed competition for the entire market is probably not needed provided that foreclosure of the remaining 50 percent of the market is exclusively in the form of above-cost rebates.

---

[12] Case C-234/89, Stergios Delimitis v. Henninger Bräu AG, 1991 E.C.R. I-935.

[13] Elhauge (2003), *supra* note 11, at 322.

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

Another safe harbor may be expressed as the incapability of the rebate system to exclude an equally efficient competitor. An equally efficient competitor is a hypothetical competitor with the same cost structure as the dominant undertaking. A rebate system may be presumed incapable of excluding an equally efficient competitor if the effective price calculated by allocating the entire discount to the contestable share of dominant undertaking's demand is above an appropriate measure of the dominant undertaking's cost.

The as-efficient-competitor test has been criticized because, in abuse of dominance cases, new entrants or smaller rivals are often less efficient than the dominant undertaking. The theory of harm of anticompetitive rebates, and many theories of harm of exclusionary conduct, is predicated on the assumption that the rivals are less efficient than the incumbent. In fact, it is the rebate system itself that prevents rivals from being as efficient as the dominant undertaking by denying them the benefit of scale economies or learning by doing. On the other hand, the as-efficient-competitor test has a clear advantage as a safe harbor because it allows the dominant undertaking to rely on its own costs to assess the lawfulness of its conduct. Furthermore, the test has recently been endorsed by the CFI, albeit in a different context.[14] It is perhaps possible to address the shortcomings of the as-efficient-competitor test as a safe harbor (that is, not as a test for abuse) by adopting a stricter cost benchmark for this purpose. While in predation analysis it is probably preferable to adopt an average variable cost or average avoidable cost benchmark, for the purpose of the rebate safe harbor it may be appropriate to adopt an

[14] Case T-271/03, Deutsche Telekom AG v. Commission, 2008 O.J. (C 128) 29.

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

average total cost or long-run incremental cost benchmark. It is important to stress that the fact that the effective price is below the safe harbor benchmark does not mean that foreclosure effect or consumer harm is established or presumed. It simply means that the dominant undertaking cannot benefit from this safe harbor and an in-depth analysis may be warranted.

If either safe harbor test is not met, the question arises as to what rules should be applied to assess the anticompetitive effects of the rebate. A number of tests have been put forward, especially in the U.S. literature, as potential candidates for assessing conduct under Section 2 of the Sherman Act.[15] In the author's view, a medium- to long-term consumer harm test should be adopted. The test could be expressed as follows: conduct is abusive if it has a foreclosure effect as a result of which there is likely to be a negative effect on price, output, or innovation (consumer harm) unless the conduct is also necessary to generate efficiencies that are not manifestly disproportionate to the consumer harm caused and are likely to be passed on the consumers. The burden of proving foreclosure and consumer harm lies with the competition authority or claimant, while it is for the dominant undertaking to substantiate any efficiency claim under the doctrine of objective justification. This test does not require any balancing exercise or measurement of countervailing factors, but a sliding-scale comparative analysis of the relative likely magnitude of efficiency gains and market power losses.[16] Furthermore, for anticompetitive rebates, consumer harm is not necessarily (and often will not be) in the

---

[15] *See*, *e.g.*, 2006 FORDHAM CORP. L. INST.: INT'L ANTITRUST L. & POL'Y ch. 18-23, 409-597 (B. Hawk ed., 2007).

[16] S.C. Salop, *The Controversy over the Proper Antitrust Standard for Anticompetitive Exclusionary Conduct*, in 2006 FORDHAM CORP. L. INST.: INT'L ANTITRUST L. & POL'Y 477, 484 (B. Hawk ed., 2007).

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

form of higher prices or lower output in a second phase after rivals have been excluded or marginalized. Consumer harm may be (and often is) in the form of the maintenance of market power or slowing down of the process of its erosion through effective competition. Finally, consumer harm could be in the form of a negative effect on rivals' incentives to innovate in the medium or long term.

IV. CONCLUSION

In conclusion, it appears possible to devise a workable analytical framework for analyzing allegedly anticompetitive rebates. This is all the more necessary in a system of decentralized application of Article 82 by the European Commission, the EU national competition authorities, and national courts. However, the current case law of the Community Courts is not entirely satisfactory and the only way to move the law and policy forward would appear to be the publication of principle-based guidelines by the European Commission. Such guidelines should provide for a flexible analytical framework combined with meaningful safe harbors, but they should avoid the somewhat still prescriptive approach of the Discussion Paper.

The Discussion Paper was published in December 2005. "Attendre et espérer."

Competition Policy International, Inc. © 2008. Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.