



## When are Rebates Exclusionary?

The application of Article 82 to rebates offered by dominant firms is one of the most controversial issues in competition policy today. Two high-profile decisions by the Court of First Instance (CFI) in 2003 on cases involving Michelin and British Airways have revived a never-settled debate in Europe on the circumstances under which discount schemes by dominant firms can have exclusionary effects and infringe Article 82.<sup>1</sup>

Much of the controversy generated by the CFI rulings has arisen from the fact that they appeared to introduce virtually a *per se* rule against a particular form of quantity discounts by dominant firms – namely, *retroactive* rebates. A widespread reaction by several commentators has been that, given the pervasiveness of retroactive rebate schemes and their potential efficiency benefits, an *effects-based* analysis centred on economic principles would be more appropriate for their assessment under Article 82. A rigid prohibition would run the risk of discouraging potentially efficient pricing behaviour in those cases where the exclusionary risk is minimal.

This memo contributes to the debate by outlining certain key economic principles that we have developed to assess the effects of rebates in the course of our case work, and proposing a workable analytical approach for the quantitative analysis of retroactive discount schemes.

### Retroactive rebates

Under retroactive rebate schemes customers obtain a discount on all the quantities purchased if a certain level of purchases is met (i.e. a volume threshold).<sup>2</sup> The discount therefore also applies retroactively to volumes up to the threshold. The retroactive nature of the rebate means that the marginal price (for a small quantity increment under the contract) is negative when the quantity purchased moves above the threshold at which the rebate kicks in. It also implies that there is a discontinuity in total expenditure under these schemes: total expenditure falls when the volume threshold is reached. As an illustration, consider a retroactive rebate scheme under which a seller offers a 5% rebate on a unit price of €1 if quantity purchased is 1000 units or greater. Under this scheme expenditure falls from €999 to €950 as demand increases from 999 to 1000 units (i.e. the price for the demand increment is negative).

In the Michelin and British Airways cases, the existence of negative incremental prices and the discontinuities implied by retroactive rebates led both the European Commission and the CFI to consider these schemes as ‘loyalty-inducing’, and therefore in violation of Article 82. In both

cases it was argued that rivals to the dominant firm would have to offer very low prices to compete for incremental volumes. Moreover, the *retroactive* nature of the rebates could not be justified by *incremental* cost savings associated with higher sales, and therefore there could not be any ‘objective justification’ for the existence of the discount scheme.<sup>3</sup>

When considering the competitive impact of such schemes, it is important to recognise that they are a common business practice. Firms in competitive markets commonly make ‘three-for-two’ or similar offers, which are effectively retroactive rebates. These discount schemes may represent a form of healthy price competition between firms.<sup>4</sup> Well-known results on the effects of price discrimination by firms with market power also show that quantity discounts may expand volumes.<sup>5</sup>

Part of the reason why retroactive rebates are commonly used is that they represent a simple way of granting volume discounts to customers. They allow the use of one price for all purchases (rather than multiple prices for different volume tranches), and they can easily implement a scheme whereby large customers pay one price (in recognition of greater purchases), whilst smaller customers pay a different price. Implementing a scheme of this type using incremental discounts would be more complicated, and could possibly discourage volume rebates.

Given the possible welfare benefits of retroactive rebates, a blanket prohibition of all such schemes by dominant firms under Article 82 could discourage potentially efficient behaviour. One of the attractions of a *per se* approach however is that it can provide some legal certainty. A key question is therefore whether the benefits of an effects-based approach can be captured without compromising legal certainty. We outline a practical framework that contributes to this question below, focusing on the likelihood of foreclosure.

### A simple analytical framework

In constructing this framework, an important starting point is to note that there is a range of circumstances under which a retroactive rebate scheme does not have exclusionary effects. For example, if the total coverage of contracts with retroactive rebates is limited (in terms of percentage of total market demand they account for), the presence of retroactive discounts should not significantly affect the entry or exit decisions of a rival to the dominant firm. Similarly, if rivals can compete effectively for contracts before they are

<sup>1</sup> CFI cases T-203/01, *Michelin v. Commission* (September 2003), and T-219/99, *British Airways v. Commission* (December 2003).

<sup>2</sup> Rebate schemes may have multiple thresholds. We focus on the case of a single threshold for simplicity in this exposition.

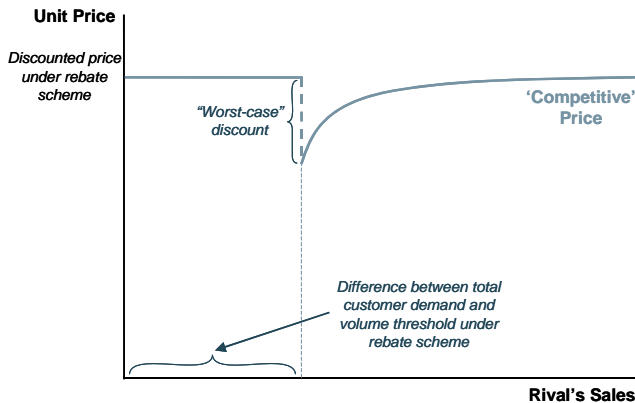
<sup>3</sup> See for example paragraphs 282-284 of the CFI decision on British Airways.

<sup>4</sup> See the OFT’s draft guidelines on ‘Assessment of Conduct’ (April 2004).

<sup>5</sup> In principal-agent settings, volume discounts may also constitute an efficient mechanism to reward efforts by an agent.

entered into, then the fact that these contracts contain retroactive rebates is unlikely to lead to exclusion.<sup>6</sup>

In terms of contract-specific features, one of the key empirical conditions to be tested is whether the total demand by the customer is near the volume threshold specified in the rebate scheme.<sup>7</sup> A contract will only have exclusionary effects (if at all) in the proximity of the threshold (where incremental prices are negative). It can therefore have only limited anti-competitive implications if demand under the contract is far from the threshold. This basic feature of retroactive rebate schemes can be illustrated by computing the average price that a rival firm would have to offer in order to match the effective price offered by the dominant firm. This 'competitive' price is shown in the figure below, in relation to the discounted price under the rebate scheme, and as a function of the sales made by the rival firm to the customer.



The figure illustrates the situation where buying the product from a rival may imply losing the volume rebate offered by the dominant firm – i.e. the case where the customer's total requirements exceed the volume threshold for the rebate. As long as sales by the rival firm do not exceed the difference between total demand by the customer and the volume threshold indicated in the rebate scheme, the customer would still buy a sufficient quantity from the dominant firm to qualify for the rebate. The price to be offered by the rival in order to be competitive is therefore equal to the discounted price under the rebate scheme (€0.95 per unit in the numerical example given above). As soon as the rival's sales go above this level, the unit price that a rival would need to offer to be competitive with the dominant firm drops to a lower level. This is because the customer, by purchasing more of the rival's quantity, would lose the retroactive discount that would have been granted by the dominant firm, and would need to be compensated for this loss (€49 in the example).<sup>8</sup> However, as volumes sold by the rival firm increase, the loss of the retroactive rebate suffered by the customer as a result of purchases made outside the rebate scheme can be absorbed over a larger volume base, allowing the price offered by the rival to

converge back towards the discounted price charged by the dominant firm.

## Assessing exclusionary effects

The price schedule plotted in the figure provides a simple and yet powerful summary of the potential exclusionary effects of a retroactive discount scheme. If total demand by the customer (over the relevant contractual period) is significantly above the threshold specified in the contract with the dominant firm, then rival firms will be able to compete on an equal footing with the dominant firm for significant volumes (i.e. up to the difference between total demand and the threshold). Moreover, in such circumstances, the *maximum* price discount that a rival would have to offer (in addition to the one granted by the dominant firm) would be relatively small, so that competition for additional sales is also unlikely to be significantly impeded.

It is possible to show that the size of this 'worst-case discount' (as indicated in the figure) is simply equal to the ratio of the percentage discount offered by the dominant firm, and the percentage difference between total customer demand and the volume threshold. Consider the example given above (a 5% retroactive discount if volumes exceed 1000 units), and assume that total customer demand is 1500 units (50% above the threshold). In this case the 'worst-case' discount to be offered by a rival supplier would simply equal 10% (i.e. 5% over 50%). A rival may not even need to offer such a 'worst-case' discount; if a customer wishes to purchase from the rival more than the difference between its total demand and the volume threshold under the rebate scheme, then the required discount will be smaller (as illustrated by the rising price schedule in the figure). Predation-style cost tests could be applied to assess whether the level of discounts required by the rival firm in order to be competitive could be seen as exclusionary (e.g. by comparing these discounted prices to the relevant costs of the rival and of the dominant firm).

## Conclusion

Advocates of a *per se* rule argue that an effects-based approach is just not practical; the need to identify and quantify the economic effects of a specific conduct by a dominant firm does not provide sufficiently clear directions as to what constitutes acceptable behaviour under Article 82. Yet such a view also means that the potential efficiency benefits associated with certain practices – in this instance volume rebates – would be lost. It is true that assessing potentially exclusionary effects is often complex. However, as this memo has outlined, a simple and economically meaningful analysis of retroactive rebate schemes is feasible, and can yield considerable insights into their potential impact on competition. The adoption of such an approach can help clarify the definition of what constitutes 'acceptable' behaviour by dominant firms, while at the same time providing robust checks and balances against exclusionary conduct.

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<sup>6</sup> For example, large suppliers could tender for sizeable contracts containing retroactive rebates. As long as ex-ante different suppliers can credibly compete for these contracts, it would not be correct to argue ex-post that these contracts are exclusionary.

<sup>7</sup> This assessment can be made ex-ante on expected demand, or ex-post on realised demand.

<sup>8</sup> This assumes that the customer cannot increase its demand in order to still obtain the retroactive discount, which is a conservative assumption in the context of this analysis.