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Exclusionary abuse II: An introduction to rebates, margin squeeze and refusal to supply

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Topics

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- **What is effects-based analysis?**
- **Rebates: economic tests for measuring capability of foreclosure**
- **Rebates: Pro-competitive effects**
- **Intel and other recent judgments**
- **Introduction to margin squeeze / links to refusal to supply**

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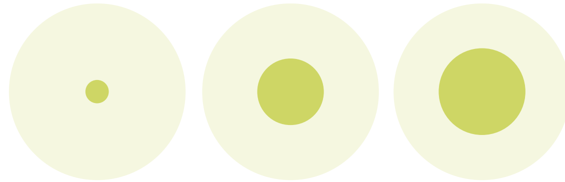
What is effects-based analysis?



What is effects-based analysis?

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- **Judging abuse by its (likely) effect on competition as opposed to the form of the conduct**
- Proponents of effects-based analysis often also argue that:
  - Abuse should be determined based on a fact-based and coherent theory of harm to competition
  - Abuse should at least have a "likely" adverse effect, as opposed to merely being "capable" of harm
  - The size of the adverse effect should be "material"
  - A consistent definition of foreclosure is required across different types of alleged abuses as well as vertical agreements and mergers
  - Legal certainty can be improved by economically coherent frameworks and safe-harbours

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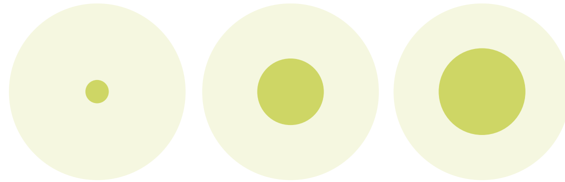
Economic Assessment of Conditional Rebates



Introduction

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- Definitions of conditional rebates
- A framework for assessing foreclosure
- The concept of the as efficient competitor test applied to conditional rebates
- Pro-competitive effects of conditional rebates
- Concluding remarks

Definitions of conditional rebates

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- **Share of needs rebate (market share rebate)**
  - Discount conditional on percentage of buyer's requirements sourced from supplier
- **Lump sum rebate**
  - Buyer obtains fixed payment when reaches target
- **Incremental rebate**
  - Buyer obtains discount on each unit purchased after the target
- **Retroactive rebate ("all units discount")**
  - As if buyer obtains discount on units purchased after the target AND lump sum (equal to discount multiplied by the target)
- **Standardised vs customised**
- Inter alia, *Intel* concerns lump sum + share of needs rebate (customised)
- *Post Danmark II* concerns a standardised retroactive rebate scheme.

What is foreclosure?

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- With exclusionary rebates we generally are concerned with customer foreclosure
  - *A practice whereby a dominant supplier prevents a rival supplier from accessing sufficient customers…*
  - *such that the rival supplier operates at a substantial competitive disadvantage…*
  - *the effect of which is to raise prices for end customers.*
- Many practices which harm rivals and make them smaller may be benign or pro-competitive (e.g. a straightforward price cut).
- Guidance Paper (2009)* refers to "anti-competitive foreclosure" for this reason.

* Guidance Paper on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (**Guidance Paper, 2009**)

Evidence on the capability of foreclosure

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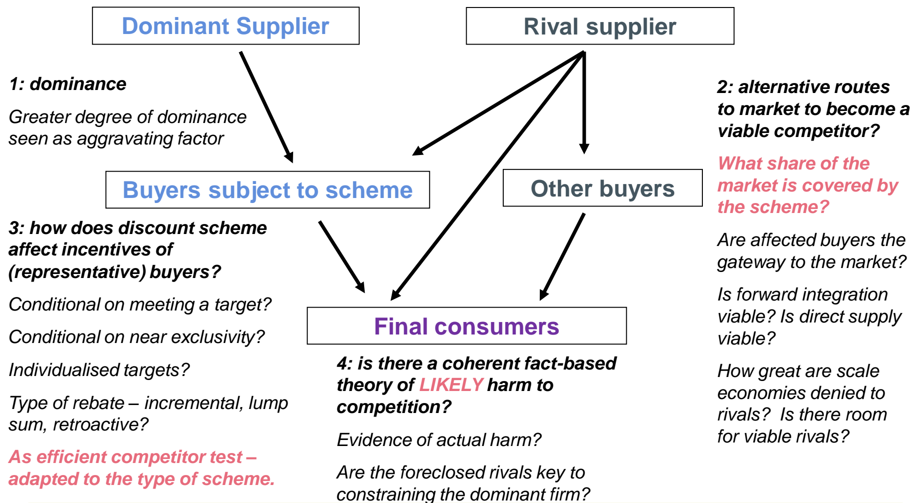

As efficient competitor tests

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- Price-cost test.
- May be used as “safe harbour” tests and/or to complement the initial screens above.
- **Concepts:**
  - If the price exceeds a certain measure of cost, then an “as efficient competitor” (in all respects, e.g. quality too) could compete with Domco. Competition law does not “protect” less efficient competitors.
  - Self-assessment. Domco knows its own costs but not its rivals’.
- **There is no economically correct measure of cost – it is simply a question of where you set the bar for intervention.**
- Guidance Paper (2009) highlights “average avoidable cost” and “long run average incremental cost” for conditional rebates.*
- The following framework is robust to both cost measures and so we refer to the “**appropriate measure of cost**”.

* Guidance Paper has footnote which mentions possibility of less efficient competitor test.

Incremental rebate – discount applies after target only

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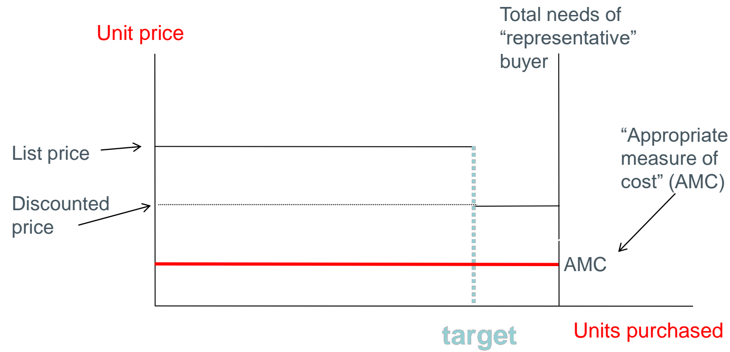

Price-cost test is straightforward: is discounted price above measure of cost? P > AMC is "safe".

Retroactive rebate – when reach target discount on ALL units

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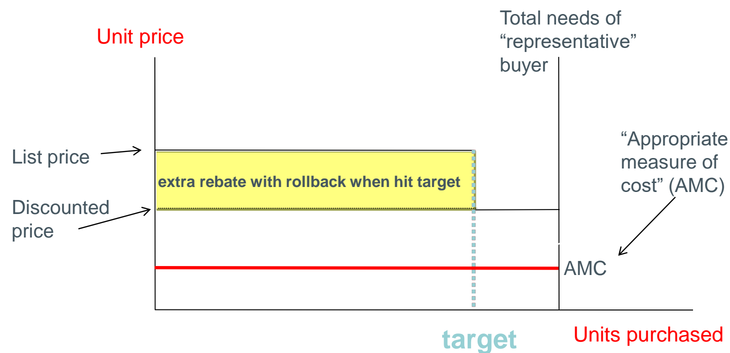

Note: Intel rebate structure is very similar to a retroactive rebate because the buyer receives lump sum discount when target is met.

Retroactive rebate – price cost test

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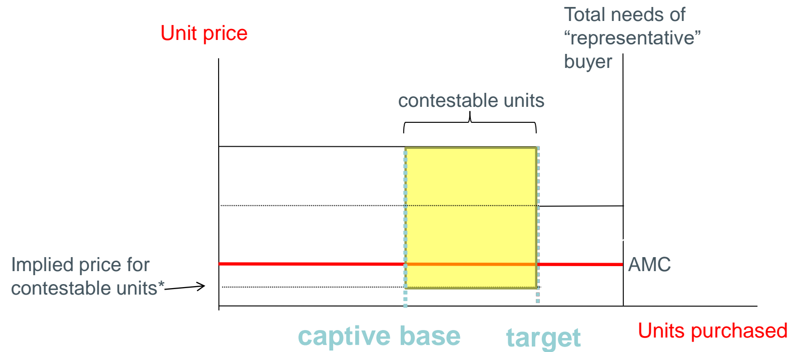

If the representative buyer is locked-in to purchasing the "captive base" (at the list price) then the discount can be allocated to the "contestable" units.

* Assumes willingness to purchase captive base at list price

How might an as efficient rival respond to a rollback rebate?

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- **Compete for sales within target range. This requires compensating the buyer for failing to obtain the rollback rebate.**
- Is it profitable for an as efficient rival to grow sales and leave the buyer no worse off? Not if the implied price is below cost.
- But should the efficient rival be willing to take a short term loss on contestable units?
- **Compete for sales outside target range.**
- This includes growing the buyer's demand (e.g. through differentiation or promotional effort).
- Is the discounted price above cost (as with incremental rebate)?
- **How close to the buyer's total needs is the target?**

What theory of harm?

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- **Why foreclose an as efficient rival from "contestable sales"?**
- Theory 1: Contestable sales are a platform for attacking the rivals' captive base. Foreclosing contestable sales is a way to protect the captive base. ("Defensive leverage" type theory.)
- Theory 2: Even though the rival would never compete against captive sales, forcing it out of the contestable range allows future higher pricing on that range. (Predation / raising rivals' cost type of theory.)
- Under the preceding theories consumers may ultimately suffer through paying higher prices (than would otherwise have occurred).
- With differentiated products, there may also be harmful effects through distorting customer choices or delaying the introduction of innovative products.

Ambiguous effects in theory

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Richer contractual structure with which to overcome asymmetric information

- Majumdar & Shaffer, JEMS (2009) – screening model, dominant firm, fringe with competitive product
  - Market share targets are profitable but have ambiguous welfare effect
  - May distort product choice but increase output for "low types"
- Calzolari & Denicolo, AER (2013) – screening with symmetric suppliers
  - Allowing suppliers to condition on whether or not a buyer purchases from a rival is beneficial relative to competition in non-linear contracts
  - But market share targets are harmful with symmetric suppliers relative to when only exclusives are possible
- Calzolari & Denicolo, AER (2015) – exclusive contracts and market dominance
  - Focus on exclusives (not market share targets) but important paper
  - Competition in non-linear tariffs (with symmetry akin to Bertrand in utility space)
  - When incumbent has major advantage, it can screen effectively which may lead to exclusion (especially for low demand states)

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Pro-competitive Effects – Conditional Rebates (I)

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Bring price closer to cost on "marginal units", while allowing fixed cost recovery on "infra marginal units"

- e.g. incremental rebates
- can promote downstream competition among different size retailers: small retailers can then procure on as advantageous terms as larger retailers thereby enhancing downstream competition
- But note Inderst & Shaffer (2010) – market share targets can dampen downstream competition among a dominant firm's distributors, where the latter can also purchase a competitively supplied rival good (the share target allows more effective dampening of *both* intra- and inter-brand competition compared to own-supplier contracts).

Incentivising promotional efforts of downstream firms, when their effort is hard to monitor

- Target is required to induce extra effort (e.g. distributor has to promote Domco's goods effectively to reach target, too costly to monitor that promotional effort directly)
- Demand volatile, so share of needs target 'controls' for demand shocks (form of risk sharing or efficient way to deal with incomplete information)

Pro-competitive Effects – Conditional Rebates (II)

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Combining appropriate incentives to invest with a buyer's desire to stock a second supplier

- Establish setting for Domco's investment in distributors, by preventing distributors using that investment to benefit a rival supplier (too costly for Domco to monitor this directly)
- Buyer may value second supplier (differentiation, second source of supply, resilience)
- Share of needs target allows Domco confidence that its investment is not used to sell too much of its rival's product (and so makes its initial investment worthwhile)

A note on compliance

- If a dominant firm wants to use conditional rebates (especially those with lump sum elements), it does make sense to have a sound pro-competitive rationale even if foreclosure is considered to be unlikely.

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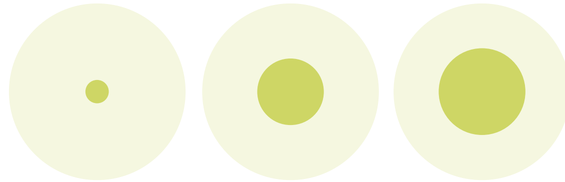
Legal Context: Intel and other recent cases



European Commission stage (I)

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- Intel fined €1.06bn for abuse of dominant position
- **"Naked restrictions"** – channel restrictions for AMD sales, postponed launches of AMD-based desktops and laptops (HP, Acer, Lenovo)
- **"Exclusivity rebates"** – payments to major original equipment manufacturers (OEMs) and a key distributor Media Saturn Holdings (MSH) were conditional on (near) exclusivity

European Commission stage (II)

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Commission found that Dell and HP were of particular strategic importance ("gateway buyers"):
- largest buyers and operate in all segments
- strong presence in most profitable part of market (e.g. enterprise)
- can "legitimise" a new CPU

Dell and HP understood certain payments to be **conditional on (near) exclusivity** to Intel and could not coordinate to sponsor entry.

Dell and HP had captive and contestable units – Commission applied AEC test (using AAC measure of cost over one year).

General Court

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Rejects Intel's appeal on substantive matters finding, inter alia, that:

"Exclusivity rebates" are presumed abusive

- Exclusivity rebates are "share of needs" rebates where target is conditional on buyer sourcing large (75%+) share of its needs from dominant supplier.
- This presumption applies irrespective of the share of the market foreclosed!
  - No *appreciability* test.
  - AEC test is not required and "passing it" does not imply absence of abuse.
- More generally, a rebate can be "fidelity building" (and unlawful) because access to the buyer is "made more difficult" for the rival supplier (here, not presumed exclusive – "all the circumstances" must be considered).
- Objective justifications? Only in exceptional circumstances. ☹

CJEU

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There are many interpretations but here's mine…

- HLR (described at 137) creates a presumption of foreclosure with respect to "fidelity rebates" but the dominant firm can rebut that presumption with "**supporting evidence**" (whether by using an AEC test in the price-cost sense and/or other evidence that an as efficient competitor would not be foreclosed) that its conduct was not capable of restricting competition and, in particular, of producing the alleged foreclosure effects (138).
- In that case (which will presumably be all cases because a dominant firm will not just give up…) the Commission has to analyse the dominant firm's arguments. Having done so, if the Commission finds an abuse then, on appeal, the General Court will have to review the dominant firm's arguments/evidence.
- Before considering an objective justification, the Commission must conduct "an analysis of the intrinsic capacity of that practice to foreclose competitors which are **at least as efficient as the dominant undertaking**".
- If the Commission itself uses an AEC test and the dominant firm finds fault in that test, the General Court must analyse the dominant firm's arguments on appeal.
- **Economists will be employed to gather supporting evidence that as efficient competitors will not be foreclosed by the rebate in question. ☺**

Does the AEC test and AEC thinking have a future?

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Yes! ☺

AEC Test

- Predation and selective price cuts (Akzo, Post Danmark I)
- Rebates (Intel)
- Margin squeeze (Deutsche Telekom, Telia Sonera)
- Guidance Paper on Enforcement Priorities

AEC thinking: in Intel, impact on as efficient competitors identified in paras. 133-134:

"*…no way the purpose of Article 102 TFEU to prevent an undertaking from acquiring, on its own merits, the dominant position on a market. Nor does that provision seek to ensure that competitors less efficient than the undertaking with the dominant position should remain on the market*"

"*…not every exclusionary effect is necessarily detrimental to competition. Competition on the merits may, by definition, lead to the departure from the market or the marginalisation of competitors that are less efficient and so less attractive to consumers from the point of view of, among other things, price, choice, quality or innovation*"

But let's not get too excited…

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- But remember the wider context in which the AEC price-cost test fits! It is just one possible part of the foreclosure assessment. **And note case-law that is in a different spirit…**
- *Degree of dominance?*
  - The test is not relevant if the rival could never be as efficient as Domco?
  - Compare formerly state-owned monopolies with very high shares where competition from less efficient rivals may be important (Post Danmark II)
- *Appreciability?*
  - Post Danmark II – the effect must be likely but does need to be serious.
  - But why do we care about a likely impact on a very small part of the market?
  - Note: Intel does refer to the importance of considering "market coverage"
- *Denial of scale economies?*
  - Tomra: "the foreclosure by a dominant undertaking of a substantial part of the market cannot be justified by showing that the contestable part of the market is still sufficient to accommodate a limited number of competitors".
  - But if the rivals can achieve an efficient scale, they still constrain Domco effectively.

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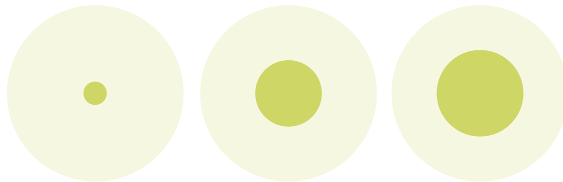
Margin Squeeze and Refusal to Supply



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Margin squeeze (I)

- **The margin squeeze test (stylised example)**
- An integrated monopolist produces a critical input ("crinput"), which is the upstream product
- This is the only input required to make a downstream product called a "gadget"
- The integrated firm sells crinputs at W per unit to third parties
- The integrated firm also sells gadgets (which it makes with its own crinputs) at a retail price of P per unit
- The integrated firm's downstream cost of turning crinputs into gadgets is D per unit
- Under an **as efficient competitor test (AEC)**, in the context of a margin squeeze, the question asked is as follows:
- ***Could the integrated firm profitably sell gadgets at their current price if it bought widgets at the price it charges third parties?***
- In other words, does (P – W) exceed D? Note benchmarking against monopolist's costs.

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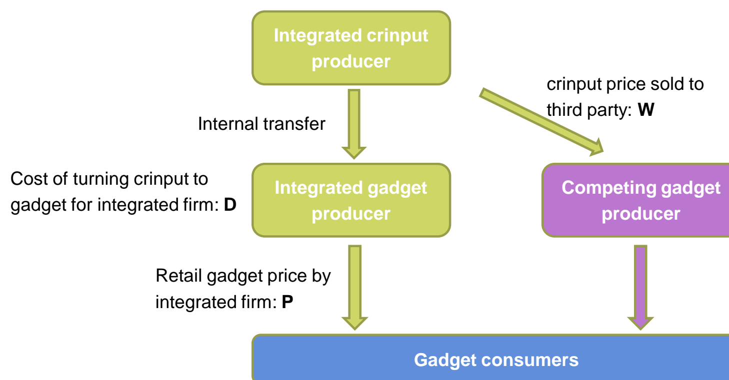
Margin squeeze (II)



"Margin squeeze test": P – W > D (test passed). P – W < D (test failed)

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Some issues in law

- **Stand-alone abuse**
  - Not judged against RTS standard. Neither a predation abuse, nor an excessive wholesale pricing abuse. It is an issue of relative prices.
- **Cost benchmarks and effect:**
  - Use of AEC test (*Deutsche Telekom, Telefonica, TeliaSonera Sverige*)
  - Guidance Paper on EP suggests LRAIC as relevant cost benchmark.
  - NB: Legal certainty (DomCo knows own costs)

  *"in order to establish that a practice such as margin squeeze is abusive, that practice must have an anti-competitive effect on the market, although the effect does not necessarily have to be concrete, it being **sufficient to demonstrate that there is a potential anti-competitive effect which may exclude competitors who are at least as efficient as the dominant undertaking**"* (CJEU, *Telefonica*, para. 124)

- **Aggravating but not necessary factors**
  - indispensability of the input, [degree of dominance?]
- **Factors not "relevant" to the existence of an abuse** (see, e.g. CJEU in *TeliaSonera*)
  - whether existing customer or potential customer excluded
  - absence of regulatory obligation to supply
  - absence of downstream dominance
  - opportunity to recoup losses
  - maturity of markets, new technology, and the need to recoup substantial investments

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Some issues in economics (I)

- **Chicago type arguments:**
- No incentive to exclude more efficient firms or firms serving differentiated markets
- With homogenous products, downstream firms can operate profitably if they are at least as efficient as DomCo in the downstream market.
  - **Example: With more efficient firms, DomCo uses W to extract rent and P to limit double marginalisation, with no intention to exclude.**
- With sufficiently differentiated products, downstream firms can operate profitably even if the test is failed.
  - **Example: DomCo charges high W to a downstream firm that sells high quality product into high demand market with no intention to exclude.**
- **Links to other areas:** refusal to supply, bundling, vertical restraints/mergers
- Monopolist may wish to tie its hands to encourage downstream investment by third parties.

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Some issues in economics (II)

- **What is the theory of harm?**
- Extraction of upstream market power
  - Including overcoming regulation (e.g. cannot extract profit upstream due to regulation so monopolise downstream instead)
- Exclusionary motives:
  - Predation
  - Defensive leverage (e.g. to prevent the development of downstream platform that would facilitate upstream entry)
- **Practical matters**
  - Cost allocation
  - Profitability forecasts and assessment of normal profit (period by period approaches, DCF, customer cohorts)
  - Dynamic markets (e.g. short run failure of test, long run pass)
  - Application to individual products or bundles of goods (e.g. should we assume that the equally efficient competitor offers the same bundle of products in the same proportions)?

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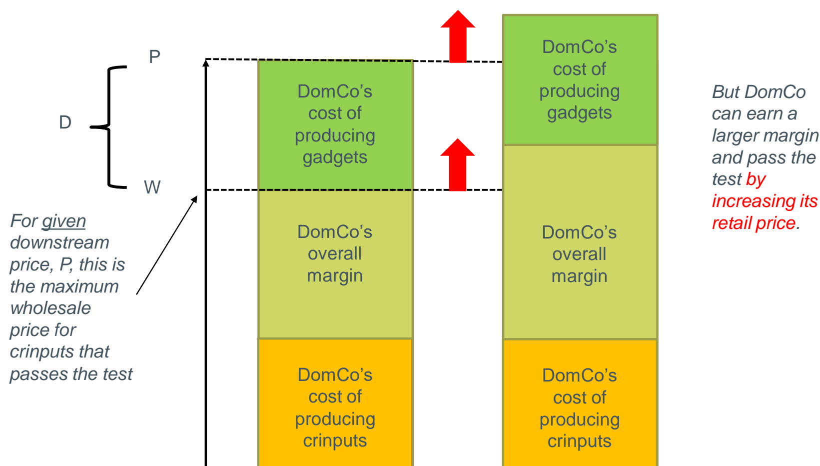
Avoiding margin squeeze – raise the retail price!



For given downstream price, P, this is the maximum wholesale price for crinputs that passes the test

But DomCo can earn a larger margin and pass the test by increasing its retail price.

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Refusal to Supply

Definitions

- … as the name suggests!
- "Constructive RTS" – supply at a price no-one will pay
- Creating incompatible products
- Denial of access / refusal to license

Theories of harm

- Can draw on literature on bundling, vertical agreements/mergers
- Note: Commission Guidance Paper (2009) does not distinguish between RTS and margin squeeze, though *legally* margin squeeze is a stand-alone abuse. (It does not have to be RTS, excessive or predatory pricing.)
- Main theory of harm is input foreclosure (notably where the dominant firm is integrated – i.e. present upstream and downstream)

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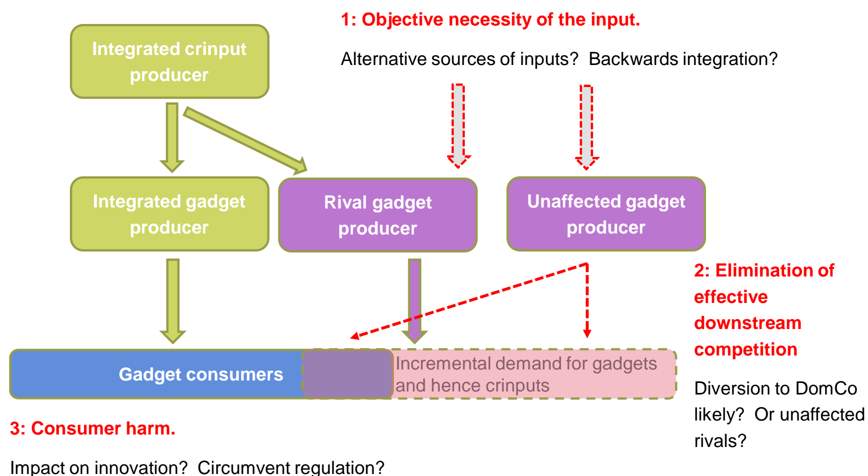
RTS/Margin squeeze – Input Foreclosure Framework



Further issues

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- Should intervention occur in the first place?
  - To what extent does this deter innovation (e.g. to create essential or important facilities) in the long run?
- What is the access price / terms of access?
  - How to monitor? Impact on quality and innovation?
- Refusal to license IP: link to FRAND literature

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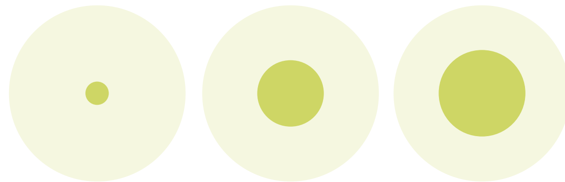
Concluding Remarks



Concluding remarks

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- Effects-based analysis means different things to different people
- There is no correct cost test. The chosen test reflects how interventionist (or not) the authority wants to be.
- Economic screens need not be complex and need not create legal uncertainty. And they can make decision making better.

Questions

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- Should competition authorities protect less efficient competitors?
- What should an as efficient competitor test mean when Domco has a different quality to its rival?
- Is margin squeeze an “easier” abuse to demonstrate than refusal to supply?

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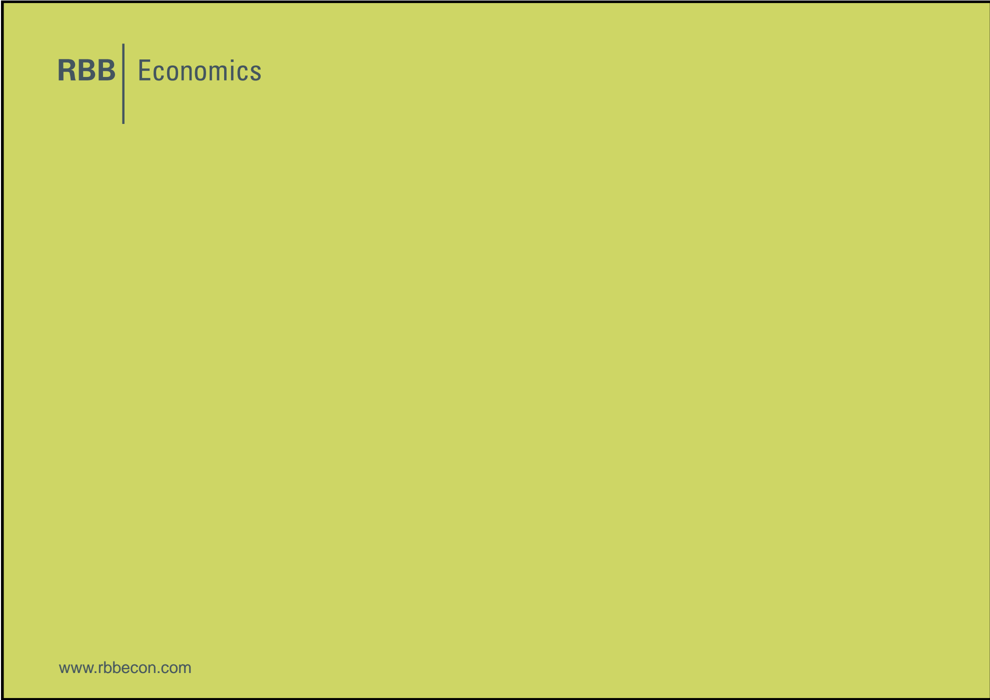
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