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A Question of Loyalty:

How to analyse loyalty rebates and discounts

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What are loyalty rebates?

Incremental rebate

- Buy coffee cups for $3 each
- Get 10th cup at $3 rebate (here: all cups at 10 or above are free)
- Marginal price for 10th cup = 0

Retroactive rebate

- Buy coffee cups for $3 each
- If reach threshold of 10 cups, then 30 cent rebate on *all* cups purchased
- Marginal price for 10th cup = 0

Leverage

- Entrant can only compete for 2 cups out of 10
- Attribute $3 total rebate to the 2 contestable cups
- Effective unit price for contestable demand = $1.50

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Pro- or Anti-Competitive?

Economic theories for loyalty rebates

- Efficiencies
- Predation
- Raising rivals' costs

Legal frameworks for assessment

- Simple predation test
- Predation test with attributed rebates
- Exclusive dealing test

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Pro- or Anti-Competitive?

How to define anti-competitive foreclosure

- No Economic Sense-test
- Equally Efficient Competitor-test
- Consumer Welfare-test

Administrability

- Complexity
- False negatives vs. false positives (chilling comp.)

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Loyalty Discounts and Rebates

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The Value of Loyalty Discounts

- Loyalty discounts are prevalent throughout the world and across many industries, including, for example, medical devices, pharmaceutical products, airlines, computers, and consumer products.
- Many pro-competitive benefits for buyers and sellers at both the retail and wholesale level.
- Overall, the pro-competitive benefits of most loyalty discount programs exceed any anticompetitive effects.
- Therefore, antitrust and competition agencies should consider the likelihood that any action or policy will “chill” or reduce loyalty discounts in their jurisdiction.
- Chilling loyalty discounts creates a “silent” cost, so an agency should make sure that the consideration is not drowned out by “louder” considerations like complaints from rivals or the positive publicity from an investigation.

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Loyalty Discounts Can Harm Competition

- There are certain instances where a dominant entity can engage loyalty discounts to harm a rival through predation or foreclosure.
- Anticompetitive harm can occur through below-cost pricing from discounts that an equally-efficient competitor cannot match.
- Some economic models suggest that anticompetitive harm can occur through above-cost discounts by depriving competitors of sufficient scale and thereby raising their costs so they cannot compete in the market.
- But there is not a consensus that above-cost discounts can harm competition, and the models suggesting such harm are highly complex with sometimes unrealistic assumptions or limited applicability.

Selecting the Best Enforcement Policy

- Selecting the best enforcement policy is not just a matter of determining which economic model most accurately determines whether loyalty discounts harm competition.
- Economic models are often applied to a vacuum, but enforcement policy is not.
- To determine the best enforcement policy, an agency must understand how each of the relevant players will react to various policies and, just as importantly, the certainty that an agency or court will apply a particular rule or policy.
- Public policy pronouncements (including speeches, white papers, etc.), enforcement activity, and case decisions will affect how players act.
- An agency should also consider the difficulty of applying particular policies for the agency, the courts, and sometimes even lay juries.
- Importantly, data is not always available that economic models assume in their analysis.
- Similarly, easy calculations in economic models are not always so easy in the real world with limited data and finite resources.
- Understand that any policy will likely both under-deter and over-deter loyalty discounts (in different ways).

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Pricing Decisions

- Setting a policy requiring companies to apply complex economic models that necessitate expensive and difficult analysis of market data—that may not even be available—is likely to miss its target in deterring anticompetitive harm.
- Companies are highly unlikely to expend the resources to apply these complicated models, particularly because the greater complexity often leads to greater inaccuracy in predicting how a court or agency will act.
- Thus, an economic model that, on paper, is perfect in limiting anticompetitive loyalty discounts and encouraging pro-competitive loyalty discounts, if too complex, will likely not have its intended effect.

What is the best policy?

- A price-cost test that resembles a predation test.
- It will limit false-positives, and encourage pro-competitive loyalty discounts.
- It will also limit false-negatives (i.e. anticompetitive loyalty discounts) because in most instances an equally-efficient competitor can match an above-cost loyalty discount.
- A company considering a loyalty discount can relatively easily determine whether its discounted price is below a measure of its variable cost, in part because it has access to its own cost data and does not need other market data.
- A company can also more easily predict the likelihood of enforcement or liability for its loyalty discounts, so it is more likely to offer them.

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My views and not necessarily the views of the Commission or any Commissioner

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Three Key Questions

(1) Should loyalty “discounts” be analyzed the same way as predatory pricing - i.e., under a price-cost test + a test of probable recoupment (although not all jurisdictions require recoupment)?

(2) Are either the mechanism of exclusion or the likely efficiencies of loyalty "discounts" more like predatory pricing or exclusive dealing?

(3) Are the administrability concerns that led to the use of price-cost tests for predatory pricing equally applicable to loyalty “discounts”?

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Loyalty "Discounts" as Exclusionary Conduct

- The mechanism of exclusion in loyalty “discount” and other kinds of “rebates” is not the same as with predatory pricing.
  - They do not tend to exclude solely because of the price to the buyer.
  - Exclusion is a consequence of the condition placed on receipt of the “discount” – the commitment to purchase specified amounts of product from the seller. That makes them more like exclusive dealing than predatory pricing.
- When loyalty “discounts” are anticompetitive, recoupment occurs simultaneously - there is no period of uncertain losses and uncertain recoupment, as with predatory pricing. The practice therefore may be more likely to occur.
- If these “discounts” are viewed as “payments,” they can be understood as “consideration” for the exclusivity term of the contract.

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Conditional Pricing Cases

- Consider share discounts, loyalty discounts, bundled rebates, etc. as "conditional pricing" cases, in which receiving a specific price is conditioned on agreement to some degree of exclusivity. (With predatory pricing, there is no quid pro quo.)

- Price cost tests are unrevealing in such cases - even misleading .
  - Not a bright line, cost-effective test, but a complex and resource-intensive exercise.
  - Does not measure effects; it is at best a crude proxy for intent.
  - Can lead to false negatives and false positives.
- The same is true for an "equally efficient rival" test, which incorrectly assumes that only the exclusion of an EER can be harmful to competition.
  - The goal of a loyalty payment strategy may be to keep a new rival from becoming equally efficient through achievement of scale economies.
  - Elevates production efficiency over consumer welfare.

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Exclusive Dealing Analysis

- If treated as exclusive dealing, loyalty payments would be assessed for:
  - their impact on rivals' costs or revenues; and
  - the probability that they will enhance the dominant firm's ability to exercise market power.
  - Potential efficiencies also would be part of the analysis.
  - Few would present serious anticompetitive threat.

- Does not pose greater administrability problems than the predatory pricing test and easier to filter out "weak" cases.

- Less challenging remedial process than in predatory pricing
  - Not directly ordering a firm to raise price to some "competitive" level; Instead enjoining a contractual condition to its pricing.
  - Firm is free (subject to predatory pricing rules) to compete on price, service, quality, but without conditioning advantageous terms on exclusionary contract terms.
- Will encourage unconditional price competition in lieu of selective discounts.

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Loyalty Discounts and Rebates

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*The views expressed are those of the speaker and do not necessarily reflect those of DG Competition or the European Commission

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Dominant firm pricing

- Pricing may exclude:
  - either because the price charged is particularly low: predation
  - or because a lower price is only available on condition of a certain purchasing conduct/loyalty of the customer: conditional rebates if it concerns a single product, mixed bundling in case of multiple products

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Dominant firm pricing

- Difficult area to draw line between competition on the merits and abusive conduct:
  - competition on price is one of the essential parameters of competition and a lower price will normally benefit consumers;
  - assessing harmful exclusionary effects of pricing conduct will, where reliable data are available, involve applying a price-cost test

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As efficient competitor test

- As efficient competitor test as proxy for capability to foreclose anti-competitively
- Inefficient competitors generally need not be protected by competition law
- Normally costs of dominant company benchmark for competition on the merits and used for price-cost test
- Confirmed by many judgements, most notably recently in ECJ's Post Denmark judgement

Conditional rebates

- Commission considers conditional rebates, which may lock-in customers and foreclose competitors of the dominant firm, as a form of exclusive dealing (see section IV.A of Guidance on Art 102 enforcement priorities)
- Reason: conditional rebates allow foreclosure without a sacrifice; marginal price may be low but average price may be high

a rebate that may not be a discount

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Condition for conditional rebates

- To enable such anticompetitive foreclosure without sacrifice it is generally required that competitors are not able to compete on equal terms for the entire demand of each individual customer
- If customers can and are willing to switch their total demand to competitors, then competition can take place for the customer and (only) predation remains as possible pricing abuse

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Leveraging inside customers' demand

- Where the dominant firm is an unavoidable trading partner, for instance because of its brand or production capacity, a conditional rebate may enable it to use the 'non contestable' portion of the demand of each customer as leverage to decrease the price to be paid for the 'contestable' portion of demand (that is to say, the amount for which the customer may prefer and be able to find substitutes)

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The average vs effective price

- To assess to what extent a conditional rebate will be capable to foreclose, requires to estimate what price a rival would have to offer in order to compensate the customer for the loss of the conditional rebate if the latter would switch a part of its demand.
- This effective price is not the average price of the dominant firm, but the normal (list) price less the rebate the customer loses by switching, calculated over the relevant range of sales

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The relevant range

- Relevant range:
  - for incremental rebates: the incremental purchases, i.e. purchases above threshold which gives right to rebate
  - for retroactive rebates: part of customers demand (potential) rivals can compete for, estimated by analysing:
    - customers' willingness to switch
    - rivals' capacity to expand sales and fluctuations of sales
    - realistic scale of entry
    - historical growth patterns of new entrants
- Note: rational dominant firm will make similar estimates in order to avoid giving rebates to customers who are either not willing or able to switch

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Long run average incremental costs

- The lower the estimated effective price is compared to the average price of the dominant supplier, the stronger the loyalty-enhancing effect. However, as long as the effective price remains above LRAIC, this would normally allow an equally efficient competitor to compete profitably notwithstanding the rebate, and the rebate would normally not be capable of foreclosing anti-competitively
- Case examples: Intel and Velux

Anticompetitive foreclosure

- To show anticompetitive foreclosure, the Commission will normally in addition consider other factors, such as:
  - the availability to competitors of counter-strategies
  - the market coverage of the conduct
  - evidence of actual foreclosure
  - evidence of exclusionary intent

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Efficiencies

- In case likely negative effects for competition are shown, there is still an efficiency defence: dominant firm may argue that countervailing efficiencies will avoid consumer harm, for instance by substantiating that the conditional rebate is indispensable to avoid a hold-up situation or double marginalization (see also section III.D of Guidance and the Post Denmark judgement)

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1. Do loyalty rebates only risk foreclosing rivals if the dominant firm is an unavoidable trading partner?

Should one take into consideration the size of the customer's demand which is "uncontestable" vs. "contestable"?

2. How should one determine whether a loyalty rebate prevents competitors from accessing the demand of an individual customer?

… price-cost tests, evaluating the form of the rebate, etc.

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3. Is it necessary to consider market-coverage and scale economies in order to determine foreclosure effects?

4. Should loyalty rebates that foreclose less efficient competitors be considered anti-competitive?

5. Where should the balance lie between false negatives and false positives for loyalty rebates?

… compared to the balance for e.g. predatory (linear) pricing, or de jure exclusive dealing? Are anti-competitive schemes more or less likely to occur? Are efficiencies more or less probable?

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6. Is there a trade-off between accurate economic analysis and predictability?

The UCWG Workbook chapter on objectives and principles of unilateral conduct laws states that an effects-based approach “makes it more difficult for business planners and counsel to predict whether specific conduct is likely to result in an infringement decision. This uncertainty may result in a chilling effect, as firms avoid conduct that may in fact be procompetitive and lawful.”

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7. Does the procedural and jurisdictional context have an influence on the appropriateness of a certain legal framework?

In some jurisdictions there is a higher occurrence of private enforcement and cases decided by jury. Furthermore, while some competition agencies may adopt enforcement decisions themselves, other systems are 'prosecutorial' meaning the agency must bring an action in the courts.

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8. Could a more formalistic approach be advocated for agencies that have limited resources? If so, how could such a test for loyalty rebates be designed?

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9. What method should be used to screen out loyalty rebates that are unlikely to result in anti-competitive foreclosure?

Thank you.

We now open for questions from the audience.