The Commission's Approach to Rebates

Lessons from *Tomra*

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Panel Discussion on Tomra and Rebates

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Outline*

- **Brief description of case and role of rebates**
- **Tomra's economic defence**
- **The economic framework put forward by the Commission**
- **Critique and consistency with the Discussion Paper**

* The description of the case contained in this presentation is based on: (a) the summary of the case in *Competition Policy Newsletter*, Summer 2006; (b) F. Maier-Riguad, *European Competition Journal*, 2006; and (c) G. Federico, *ECLR*, 2005

Tomra: the market

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The Commission's Decision

- **Commission fined Tomra €24m for infringement of Article 82 in March 2006**
  - Tomra used a mixture of exclusive contracts, quantity commitments and individualised retroactive rebates in the sale of Reverse Vending Machines to retailers (e.g. supermarkets)
- **The Commission found that all of these practices foreclosed entrants**
  - The total size of the "non-contestable" market amounted to roughly a third of the total market during the 1998-2002 period, across the 5 countries affected
- **The Commission appears to have considered all rebates schemes as exclusionary, independently of the ability of other rivals to match the discounts**
- **Tomra appealed the Decision to the CFI in June 2006**

Role of rebate schemes

- **The case represents a relevant test of the Commission's reform of Article 82, in particular in relation to rebates**
- **Retroactive rebates have generated significant controversy recently (e.g. *Michelin II*, *BA-Virgin*)**
  - The Commission appears to be moving away from a formal prohibition of specific rebate *structures* in its 2005 Discussion Paper (DP)
  - <u>But</u> is the Tomra decision consistent with this reform effort?
- **In its defence Tomra put forward an effects-based approach to rebates which is very similar in principle to the framework proposed in the DP**
  - Can the Commission's critique of Tomra's approach be squared with the DP?

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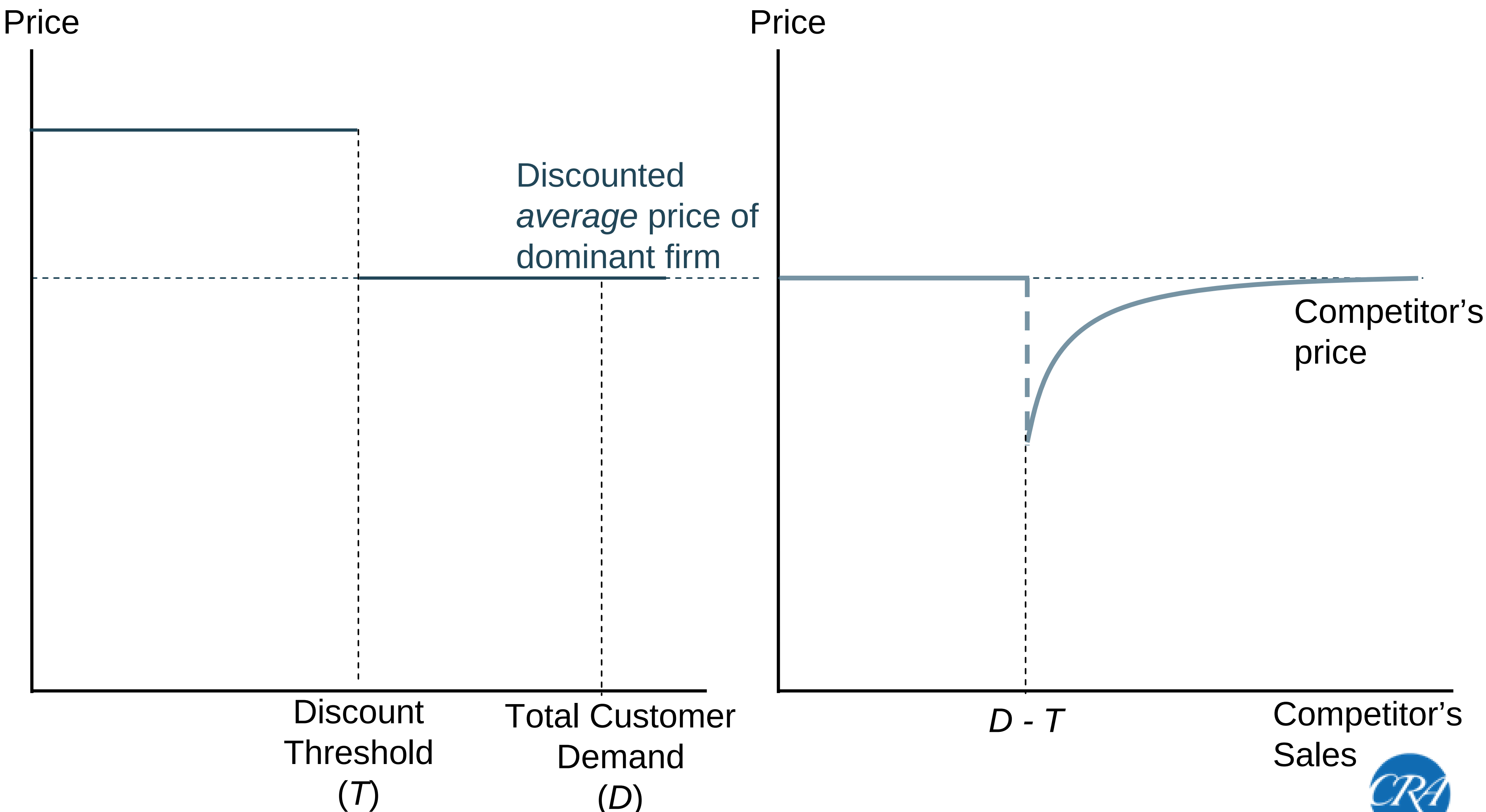
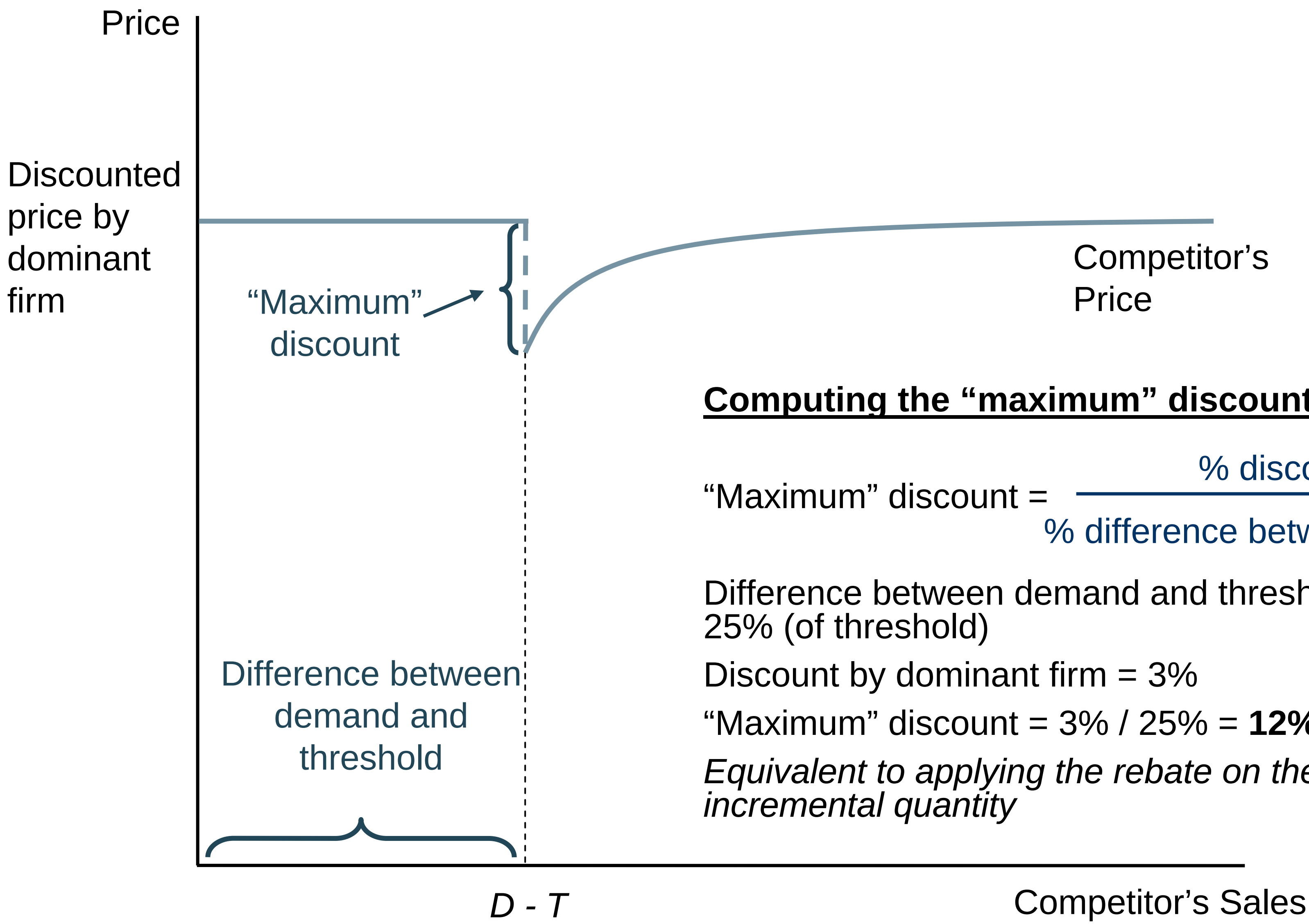
Tomra's economic case on rebates

- **Contract-by-contract empirical assessment is required, based on rival's ability to match the discounts**
- **Using simple contract parameters one can derive the price schedule that a rival would need to offer to make the customer indifferent**
- **Required parameters are**
  - The discount offered by the dominant firm;
  - Actual demand under the contract; and
  - The quantity targets in the contract
- **A *conservative proxy* for exclusionary effect is the "maximum discount" to be offered by a rival**
  - This can be compared to (expected) costs to verify whether a smaller rival can match the offer for all quantities
- **This analysis found that a substantial proportion of Tomra's rebate schemes had no foreclosure impact**
  - This mainly arises from the fact that demand was above the targets in the contracts in several cases, and discounts were relatively small

Derivation of the rival's required price schedule



Can a rival compete? The “maximum” discount



Computing the “maximum” discount

$$\text{“Maximum” discount} = \frac{\%\ \text{discount}}{\%\ \text{difference between D and T}}$$

Difference between demand and threshold = 25% (of threshold)

Discount by dominant firm = 3%

“Maximum” discount = 3% / 25% = **12%**

Equivalent to applying the rebate on the incremental quantity

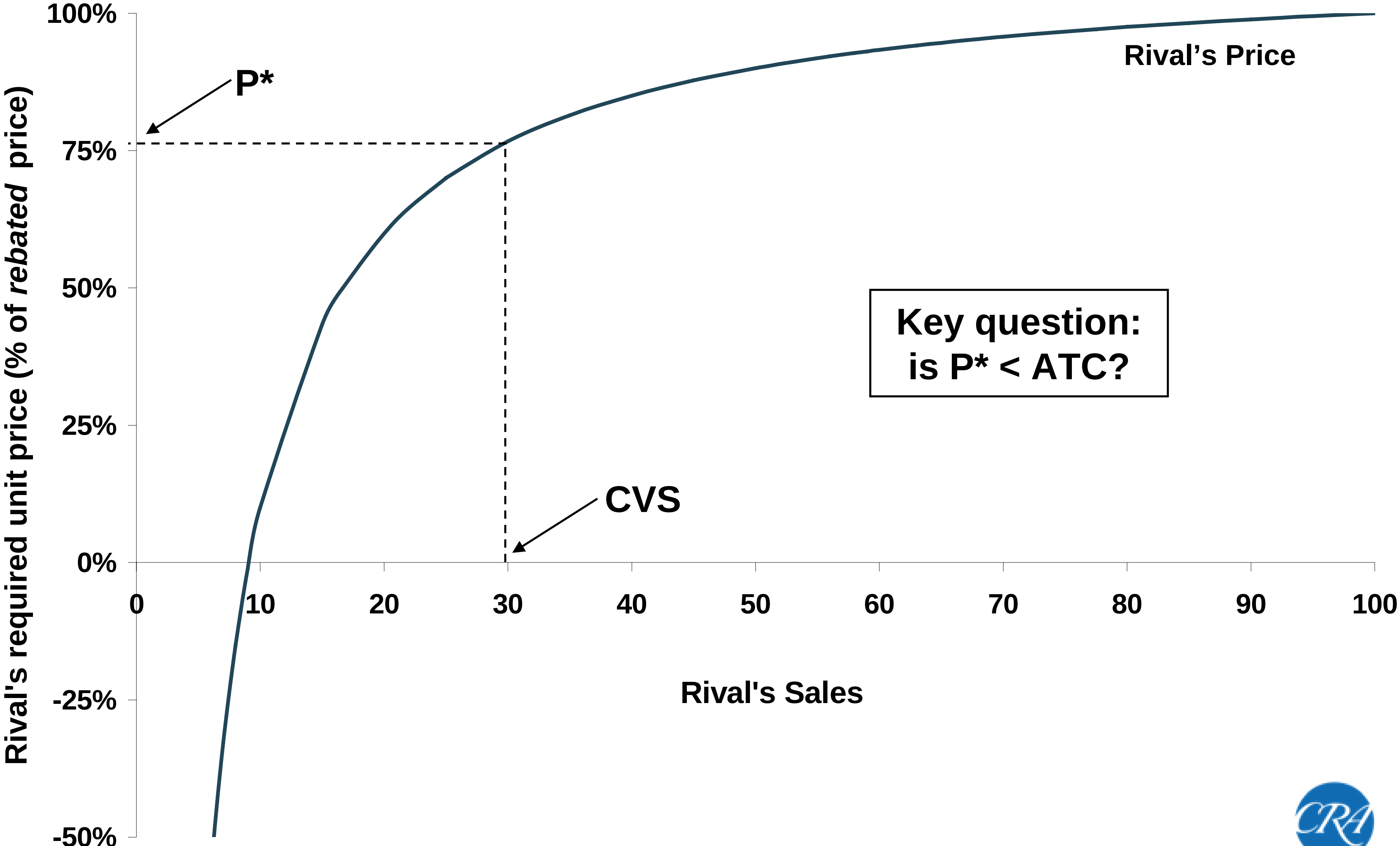
The Commission's economic case

- **The Commission appears to claim that Tomra's approach is flawed on two grounds**
  - <u>Individuality Rationality</u>: why would a rival want to compensate the buyer for foregoing the retroactive discount, and make a loss at the margin?
    - Offering the "maximum discount" does not make economic sense
    - Averaging the prices of contestable and non-contestable quantities is not valid
  - <u>Use of (ex-post) evidence</u>: the fact that *actual* demand is above the quantity targets is irrelevant to questions of *intent* and of *effect*
    - "difficult to see why Tomra would want to set the rebate threshold systematically below demand"
- **Therefore the presence of retroactive rebates forecloses <u>all competition</u> for demand below the quantity target**

Relationship with the DP - prices

- **The DP seeks to adopt an effects-based approach to rebates**
  - "*What is relevant for the assessment of the loyalty enhancing effects is not competition to provide an individual unit*" (paragraph 154)
- **This recognises that negative pricing on one marginal unit is *not* enough to establish abuse**
- **This appears to <u>contradict</u> the approach in Tomra on "individual rationality", where the presence of a negative price was enough for a finding of exclusionary effect (which is practically equivalent to a *per se* prohibition of retroactive rebates)**
- **The DP itself proposes to look at the *average* price that a competitor needs to offer at a "Commercially Viable Scale" (CVS)**
  - This goes beyond the simple observation that an individual *marginal* price is negative and therefore the contract must be exclusionary
  - The Tomra Decision does not appear to even attempt to adopt the methodology put forward in the DP

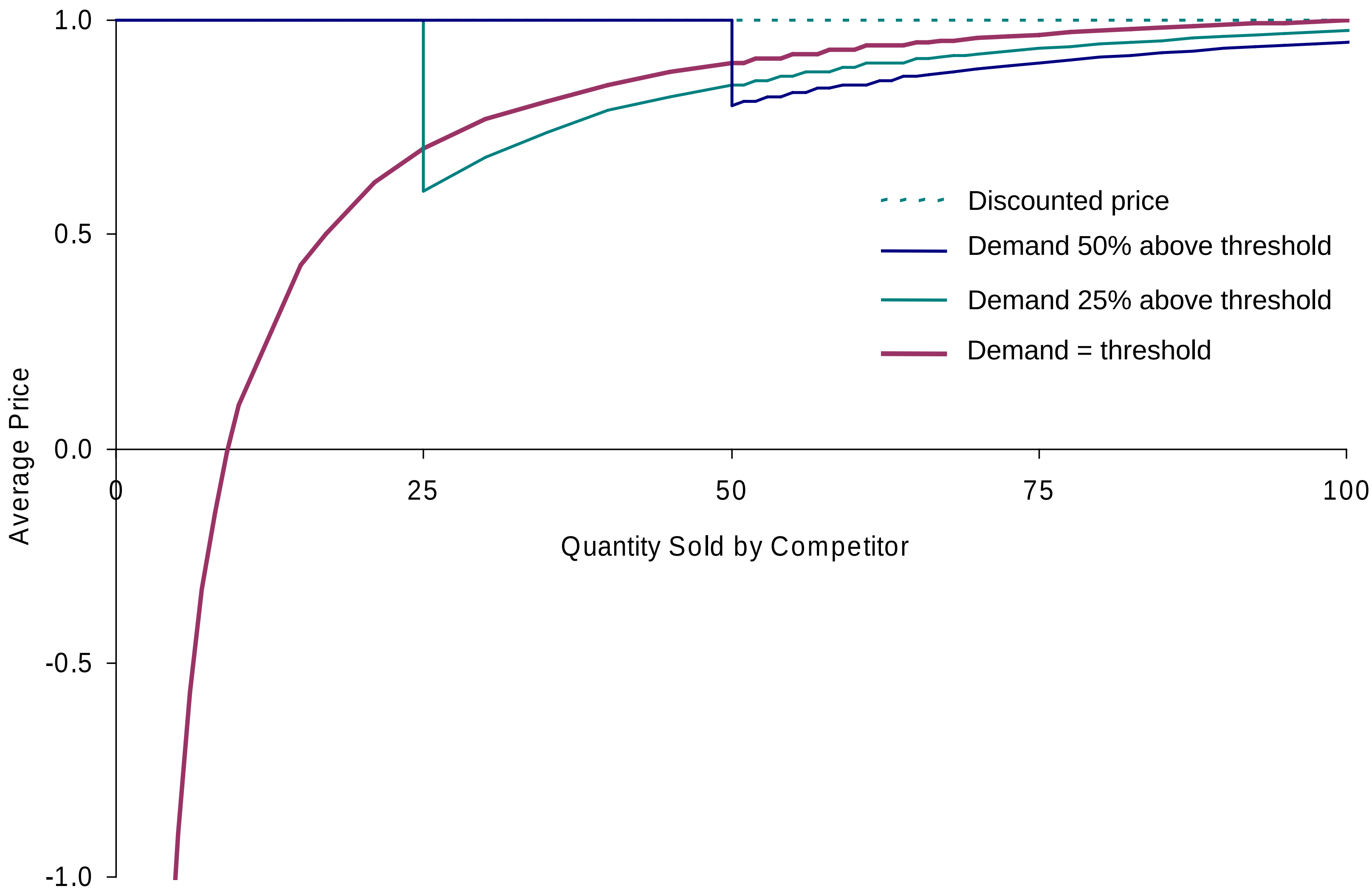
Illustration of DP's average price approach



Relationship with the DP - quantities

- **In common with the Tomra Decision, the DP also assumes that demand (*D*) will equal the quantity target (*T*) in rebates schemes**
  - However the DP states that dominant firm may rebut a finding of abuse by showing that "individualised targets are set particularly low compared to the buyers' total purchases" (paragraph 163)
- **Once the possibility that *D > T* is allowed for, the DP's economic framework is equivalent to the one put forward by Tomra (which simply generalises it to case of *D > T*)**
  - The corresponding price schedule shifts up, and drops at the "maximum discount" point
  - The maximum discount can therefore serve as a *proxy* for exclusionary effect without the need to make assumptions on CVS
- **Presence of buyer power and/or uncertainty may explain why demand lies systematically above the quantity target**
  - Multiple targets are also hard to reconcile with the position adopted by the Commission in Tomra and in the DP

Impact of relaxing the *D* = *T* assumption



Conclusion

- **The Tomra decision appears to reiterate the Commission's *formal* objection to rebate schemes**
- **The decision effectively relies on the presence of a single negative marginal price to conclude the rebates impede competition**
- **The approach is not effects-based, as it fails to take into account *observed* demand levels, and instead starts from a presumption of exclusionary intent**
- **The claim that the Tomra decision "was based and supported by economic analysis in the spirit of the […] DP" is hard to reconcile with the genuine attempt made in the DP to put forward an effects-based framework**

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