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FIDELITY DISCOUNTS AND REBATES NOT JUSTIFIED BY THE COSTS : IN WHICH CASES SHOULD A DOMINANT ENTERPRISE BE FORBIDDEN SUCH PRATICES?

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Introduction

In recent decades the divergence between antitrust enforcement in the US and in Europe has been a major area of debate in academia, in international organizations and by antitrust practitioners. These discussions proved quite fruitful and great progress has been achieved on many substantive issues, closing gaps that seemed structural and there to stay.

In the area of cartels, irrespective of the different formulations of the relevant laws, the provisions of both jurisdictions against hard-core violations are rigorously enforced—although with some differences in the nature of the sanctions (e.g. only fines for the companies in the European Community, prison terms for executives as well as fines in the United States). As for the broader area of restrictive agreements, the European Commission was strongly criticized in the past for the lack of economic reasoning used in the evaluation of the restrictiveness of vertical agreements. With the adoption of the Block Exemption Regulation on Vertical Agreements in 1999[2] and the Guidelines on Vertical Restraints in 2000[3], that gap has been filled. In this area, EC and U.S. practices are now largely convergent. One remaining difference is that absolute territorial restrictions are treated more severely in the EC than in the United States. But that is the result of the EC's commitment to the political and economic objective of creating a single common market.

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[1] Central Director for research and international affairs, Italian competition authority, Rome. I would like to thank the national rapporteurs for their very informative country reports and for their comments on a previous version of this Report: Astrid Ablasser for Austria, Ermano Fegatilli and Nicolas Petit for Belgium, Gabor Fejes for Hungary, Marcus Hartmann-Ruppel for Germany, Josh Holmes for the United Kingdom, Vlastislav Kusák for the Czech Republic, Elisabeth Legnerfalt for Sweden, Luis Moscoso del Prado González for Spain, Eleonora Ortaglio for Italy, Michel Ponsard and Pascal Wilhelm for France, Philipp Zurkinden for Switzerland. I would also like to thank the members of the scientific committee of LIDC for very helpful comments and suggestions on a previous version of this Report.

[2] Commission Regulation (EC) No. 2790/1999 of Dec. 22, 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, 1999 O.J. (L 336) 21-5.

[3] Commission Notice on Guidelines on Vertical Restraints, 2000 O.J. (C 291) 1-44.

In mergers, irrespective of the fact that the legal test in the European Community has been different from that in the United States, there has been a substantial convergence of enforcement practices. In both jurisdictions, the definition of the relevant market is strongly based on economic analysis, as is the evaluation of the substantive restrictions of competition originating from the merger. Instances of genuine disagreement have been quite rare in practice and, in general, the analysis follows very similar steps so that there is a high degree of probability that the results of a merger investigation on both sides of the Atlantic will lead to a very similar conclusion. The introduction of Regulation 139/2004[4] and the change of the substantive test have been practically irrelevant[5].

The situation is very different in abuse of dominance and monopolization cases. In the particular case of price abuses, the assessment of their restrictiveness in the European Community is mostly based on the abstract ability to exclude, more than on the actual effects. In the United States, on the contrary, the emphasis is mainly on realized effects so that, in the absence of visible and tangible exclusions, the courts have tended to conclude that there is no violation.

Indeed, while excessive pricing abuses are extremely rare in the European Community (and non-existent in the United States where high prices are not an antitrust violation), low-pricing abuses have been found to be restrictive much more frequently in the European Community than in the United States. In this area, dominant firms in the European Community are not only prohibited from effectively excluding competitors, but also from hurting them too much with aggressive pricing strategies. What counts in EC case law is the abstract possibility of excluding competitors: evidence of intent to exclude becomes a sufficient (but not necessary) element for proving the case. In U.S. case law, on the other hand, the courts require direct evidence that the practice has or will lead to an increase in market power and, in this respect, actual evidence of exclusion seems to be a very important element for proving a case.

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[4] Council Regulation (EC) No. 139/2004 of Jan. 20, 2004 on the control of concentrations between undertakings (the EC Merger Regulation), 2004 O.J. (L 24) 1-22.

[5] For a brief discussion on this see Heimler (2008) and Monti (2008).

The recent DG Competition Discussion paper on the application of Article 82 of the Treaty to exclusionary abuses proposes also in Europe a more substantive effect based approach, especially for pricing abuses[6]. No cases can be reported that documents how the new approach will be adopted in practice. This is why the initiative by the LIDC to organize this discussion on the abusiveness of fidelity discounts is quite timely.

This international Report is based on a number of national Reports that describe the relevant national experiences. The questionnaire that these national rapporteurs used as a common structure for their report can be found in the appendix. Of course not all the information available in the national reports is taken up here and therefore it is worthwhile reading them all for better understanding the detail of the experiences of different countries[7]. This international reports merely suggests a framework of analysis for assessing the abusiveness of discount and rebates, providing a critical description of the relevant experience of the European Commission and of a number of European jurisdictions.

The concept of fidelity discounts

The first question that needs to be answered is what we mean by "fidelity discounts", or loyalty discounts as they are often called. In plain language "fidelity" refers to a sub category of discounts, intended to provide either implicit or explicit compensation for loyalty (you buy only from me and I give you a discount). As such, fidelity discounts should be distinguishable from "quantity" discounts, the other sub category of discounts, where a seller provides compensation for large purchases (both for a single product and for a portfolio of products).

[6] DG Competition (2005), "Discussion paper on the application of Article 82 of the Treaty to exclusionary abuses", Brussels, Internet: http://ec.europa.eu/comm/competition/ antitrust/art82/discpaper2005.pdf.

[7] The national reports are available on line at the fllowing links: Austria http://www.ligue.org/files/rapportautrichiena.doc; Belgium http://www.ligue.org/files/rapportbelgea.pdf; Czech Republic http://www.ligue.org/files/rapportatcheque.doc; France http://www.ligue.org/files/rapporttchØqea.doc; Germany http://www.ligue.org/files/rapportaallemand.pdf; Italy http://www.ligue.org/files/rapportitaliena.doc; Switzerland http://www.ligue.org/files/rapportsuissea.pdf.

The problem with this traditional categorization, is that it is easy to structure a "quantity" discount in a way that it becomes a loyalty discount, for example by identifying total requirements on an individual customer basis and then introducing individual "quantity" discounts. This is why the distinction between "fidelity" and "quantity" discounts is much less clear than originally thought, being largely indirect and based on the "objective" justification of the provided discounts. If discounts are objectively justified (strictly cost based), as it is written in many EC decisions, then they are considered "on the merit", passing down to customers the cost reductions originating from the purchase. Otherwise they are prohibited.

The national reports provide little evidence that national jurisdictions elaborated on the notion of fidelity rebates so as to refine the traditional colloquial definition: For example the Belgian Report refers to them as discounts providing a reward for customers fidelity, implicitly suggesting that what matters is the form of the discount. The are a few exceptions. In France, according to the practice of the Competition Council and the case law of the Paris Court of Appeal, fidelity discounts are "*linked to the condition that the customer – regardless of the amount (considerable or minimal) of its purchases – sources the whole or a significant part of its requirements from the firm in dominant position*", implying that what matters is the achieved fidelity, rather than the mere structure of the discount. In Hungary there are two definitions of fidelity discounts. One is when the discount is granted in exchange of exclusivity. This mirrors the French definition. However there is also a second instance of abusive discounts, *i.e.* when the discount is granted when the sales to a given customer exceed a certain percentage of its total demand. This is a bit more controversial because the Hungarian Report does not provide any indication on the circumstances when these target discounts become abusive. A similar result seems to hold in Germany where, according to the Report, discounts that depend on the achievement of a long term turnover target are in general forbidden. In both jurisdictions it seems that introducing any target discounting is prohibited.

The issue to be discussed is clearly whether defining a system of discounts as loyalty inducing is sufficient to establish an abuse (either exclusionary, where competitors of the dominant firm are excluded from the market, or exploitative, where customers of a dominant company are put at a competitive disadvantage with one another) or, more in general, which standard is applied in the various jurisdictions in order to identify an abuse, provided a discount achieves fidelity.

The Swedish Report discusses at length the SAS frequent flyer program (FFP) case[8], an interesting case because there is no question that FFP enhances fidelity, yet in the decision by the competition Authority the restrictiveness of the SAS FFP is mostly presumed.

SAS applied its frequent flyer program (FFP) on both domestic and international flights. The antitrust authority had prohibited SAS from applying FFP on domestic flights, suggesting that FFP distorted competition domestically. FFP was considered fidelity enhancing since very little competition existed on domestic air transport and, especially for business travel, there was a hiatus between the corporation that paid for the ticket and the individual (often the decision maker) that benefited from the FFP. According to the Competition Authority, this gap between costs and benefits was very difficult to compensate by a competitor, even though the Authority did not provide any hard evidence to substantiate the charge. The market Court slightly reversed and prohibited the application of FFP only on domestics routes where SAS enjoyed a monopoly.

The Swedish FFP case can be defined as a multi-product discount, since FFP objective is to induce loyalty for all SAS air transport services, which are not in a relation of substitution for one another. The decision of the competition authority and confirmed by the Market Court is that FFP is allowed if its advantages can be competed away, i.e. it is prohibited for SAS to apply the FFP on domestic routes where it enjoys a monopoly, suggesting that the abusive nature of FFP was related to some sort of leverage. No analysis is made by the Swedish Authority on the cost reduction effect of the

[8] Judgment of the Swedish Market Court, Parties: Konsortiet Scandinavian Airlines Systems (SAS) v. Konkurrensverket (the Competition Authority), intervener Braathens Malmö Aviation AB, 27 February 2001, Case no: MD 2001:4, Appealed decision: Decision of the Competition Authority, 12 November 1999, dnr 902/1998.

SAS FFP and whether matching the discount offered by the FFP would drive a competitor out of business. There is a presumption that leveraging the FFP of monopoly routes may distort competition on routes where SAS faces competition.

A very similar position was taken by the Italian Competition Authority in the Internet Providers Association/ Telecom case[9], where Telecom Italia, by offering total turnover-based discounts , was leveraging on liberalized Internet services the monopoly it held at the time with respect to vocal services. In France the same reasoning was applied to the discounts offered by a number of dominant firms. La Poste[10] offered discounts based on its total turnover with any given customer, adding up services where it faced competition with services where it enjoyed a legal monopoly. Similarly Sandoz offered discounts on total turnover with pharmaceutical wholesalers where Sandoz was leveraging the monopoly power it held on two products, to reduce competition in markets where it faced some competition[11]. Like in the Swedish FFP case, both in the Telecom Italia, La Poste and in the Sandoz cases the distorting effects originating from multi product discounts were presumed by the fact that they were partly unreplicable. No analysis was undertaken as to whether these discounts forced competitors in the liberalized markets to price below costs.

Cost justification for discounts

Fidelity discounts are considered not abusive under existing EC case law if they are cost justified. The problem with the cost justification standard is that the Commission nowhere indicated over which additional quantities these cost savings should be calculated (i.e. savings with respect to what?). Indeed, like the Swedish example shows, the antitrust Authorities analysis is not very rigorous (nor is that of the Courts) and often truncated. The absence of a cost justification is often

[9] Italian Competition Authority, Case A255 Italian Providers' Association Telecom, decision n. 7978 of28 January 2000, published in Bulletin n. 4/2000.
[10] Comp. Coun. dec. no. 04-D-65 of 30 November 2004, practices implemented by La Poste within the framework of its sales contract.
[11] Cass. Com, 28 June 2005, n°04-13910.

presumed, even if, according to the Austrian report, *the burden of proof of a discount system non justified by cost savings rests with the plaintiff*. An interesting statement, although the Austrian Court did not appear to indicate which standards should be used and what information could the plaintiff have (unless it is the competition Authority) to substantiate his claim.

Similar to a cost saving justification is the notion that discounts may compensate for services offered by retailers. For example in Switzerland, as argued by the Appeals Committee in the Swisscom-discounts for specialist dealers judgement[12], discounts are permitted if they are related to special efforts by retailers (marketing expenses). However the Committee does not address the very important practical question of how the costs of such special efforts can be calculated by a Competition Authority and how can these extra costs be translated into discounts.

In principle, a cost justification may exist if a single order is placed at the beginning of the production period, while deliveries are distributed in the course of the year. The reduction of demand uncertainty that such a discount would reward is certainly efficient, however the actual cost savings associated with the reduction of demand uncertainty may prove difficult to measure. A cost justification may also exist if delivery of all quantities purchased occurs in a single instalment. The resulting reduction of transportation costs would be easy to prove. On the other hand, if the quantity that triggers a discount is achieved by unplanned purchases made in the course of a year, a cost justification is much more difficult to identify.

What seems difficult for European antitrust enforcers to acknowledge is that discounts provide a built-in incentive mechanism to continue buying from a given company. In this respect, discounts are often quite cheaper for the discounting firm than other more costly forms of incentives that would very rarely fall under antitrust scrutiny (e.g. telephone calls by a sales representative or an invitation to dinner or to a fancy sea resort). However, the Commission and most national authorities have never accepted (nor analysed) this incentive argument.

[12] RPW 1998/4, pp. 655-78, REKO/WEF, PTT-Telecom Fachhändlerverträge (Telecom-PTT (Swisscom) –

The Commission recently in the 2005 draft discussion paper on the application of article 82 to exclusionary conduct has promoted a more economic based approach suggesting the introduction of the as efficient competitor test: discounts are abusive, irrespective of their objective, when they force an equally efficient competitor to price below costs. This is not a new standard. There is just more rigor attached to it. Already in the Michelin II CFI judgement[13] the Court stated (paragraphs 87 and 88):

> "*... if, as in the present case, the discount applies to the total volume purchased, an increase in -turnover with the applicant from FRF 29 999 to FRF 30 000 brings the dealer an additional discount of FRF 75 (0.25% additional discount on the amount of FRF 30 000), which is 7 500% of the additional turnover achieved (FRF 75 additional discount on an additional turnover of FRF 1). ...*
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> *The incentive to purchase created by a quantity rebate system is therefore much greater where the discounts are calculated on total turnover achieved during a certain period than where they are calculated only tranche by tranche. The longer the reference period, the more loyalty-inducing the quantity rebate system.*"

What this quote suggests is that the CFI believed (in the Michelin II judgement) that a discount of 7500% can never be competed away! A non sense that the EC 2005 discussion paper is trying to overcome. The problem is the volumes over which these percentages are calculated: nobody competes on an extra French Franc of sales of tires (which is the quantity over which the discount percentage of 7500% was calculated in that case)! If the discount rate would have been calculated on the additional sales induced by the extra discount (the appropriate figure), the effective discount rates, as Heimler (2005)[14] tentatively shows for the Michelin II case, would have been much lower

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Discount Scheme for Specialist Dealers (Appeal), at ¶¶ 5.1-2.

[13] Case T-203/01, Manufacture française des pneumatiques Michelin v. Commission (Sep. 30, 2003) [hereinafter *Michelin II*], upholding Commission Decision 2002/405/EC, Michelin, 2002 O.J. (L 143).

[14] Alberto Heimler (2005), "Below Cost Pricing and Loyalty Inducing Discounts: Are They Restrictive and, If So, When?", *Competition Policy International*, 1: 149-72.

(below 2%) and it could have been easy to show that the Michelin discounting policy could have been replicated by an equally efficient competitor and would therefore not have been abusive.

The CFI rightly suggests in the quote from the Michelin judgement that “(t)*he longer the reference period, the more loyalty-inducing the quantity rebate system*”. Indeed the longer the time over which sales are accrued in order to grant a (retroactive[15]) discount, the more loyalty inducing the rebate system becomes. Indeed a three months rebate system can be replicated by a smaller competitor at ¼ the cost of a rebate calculated over one year sales. This is why the Commission is so interested in the reference period. However the exclusionary effect of target rebates does not depend only on the reference period. As Heimler (2005) shows, it of course depends much more significantly on the level of the granted discount and on the relative market share of competitors.

Replicability of the discounting policy of the dominant company only recently became an issue of concern. However there are no case in Europe (by the Commission or by the reporting jurisdictions) where discounts have been considered abusive because they would force competitors to price below costs. The relevant discussions will be taken up at a later stage.

Discounts and price discrimination

“Fidelity” discounts are meant to compensate exclusive purchasing patterns. Therefore “fidelity” discounts are inherently discriminatory and may put customers of the dominant firm at a competitive disadvantage. A purchase of 100 units may trigger a discount if they (the 100 units) cover all the needs of the acquirer for that particular product. However, a different purchaser of the same 100 units, should the 100 units not cover all of his demand, would not receive any discount (and pay a higher price than his competitor). This implies that acquirers of the same quantities may pay different prices.

[15] A retroactive discount is a discount that is granted once a customers achieves a given level of sales (for example granting a 2% discount once total revenues exceed 1 million EUR, means that at 1 million EUR of revenues a customer receives a 20000 EUR rebate, while he receives nothing if he does not reach the 1 million EUR).

The Austrian report suggests that in Austria "*(a)ny discrimination is prohibited per se, under the condition that the respective measure is capable of distorting competition*", a standard that the Commission and the European Courts have followed as well. For example in the Virgin-British Airways 2007 judgement[16], the ECJ states that "*it is undisputed that BA applied different commission rates to travel agents operating in the United Kingdom according to whether or not they had achieved their sales objectives by comparison with the reference period*". Having agreed with the Court of First Instance that the bonus schemes "*could lead to exponential changes in the revenue of travel agents*", the Court concludes that they were abusive. What this means is that whenever a fidelity discount has been found not to be cost justified, it becomes discriminatory (and therefore abusive) and, of course, exclusionary (but more on this later).

The Commission and the Courts have not been concerned with the reason why a dominant firm would find it profitable to discriminate among its customers and whether consumers would benefit as a result. Furthermore they have not been concerned with the effect on sales of such discrimination. Indeed it is a well known result of economic research that price discrimination leads in most circumstances to an increase of overall sales and is therefore welfare increasing. Only in the rare circumstances where price discrimination leads to a reduction of sales it should be prohibited.

And indeed this is the argument made by the Hungarian Authority in a case relating to the Balaton port operator. The Authority emphasized that "*undertakings have the right to use the tool of price discrimination in so far as such conduct does not cause such a disadvantage that could affect consumer welfare (as a result of a decrease in [overall] turnover)*" (Vj-38/2005 (BHRT), para 62.)

These arguments have not made it yet into most of European antitrust or, more in general, into most of European civil proceedings. According to the French Report, the French Commercial Code prohibits price discrimination by a dominant firm when two conditions are met:

[16] Case T-219/99, British Airways plc v. Commission (Dec. 17, 2003), upholding *Virgin/BA*, Case C-95/04, *British Airways v. Commission* (March , 2007)

- "*that there is a difference in treatment of partners or competitors placed in comparable situations (or, more unusually, equal treatment is imposed on partners or competitors placed in different situations),*

  that there is an absence of justification based on genuine objective reasons."

More precisely, the Court of Appeal qualifies a discount as being discriminatory where it is "*arbitrarily determined, on a case by case basis, according to a subjective appreciation of the retailer's loyalty or the competitive advantage whereby it [the company] intended, in a discretionary manner, to gratify or deprive the retailer"*[17]. There is no assessment as to how these discounts affect competition (or overall sales), whether they are profitable or not, whether they can be replicated by a competitor. The philosophy behind the Court of Appeal statement is fairness in vertical relations, a common standard in Europe at the time of the cited judgement (1990), a standard probably no longer valid today. Indeed a different language is used by the Competition Council in 2005 when price discrimination is defined abusive when it excludes competitors of the dominant firm: "*The proof of anti-competitive discrimination is brought if it is established that the bundling company applies an acquisition price for the upstream products to itself that is lower than the price it imposes on its competitors"*[18], suggesting the need of a competition analysis before concluding that price discrimination is abusive.

On the same line Heimler (2005), trying to develop a checklist for identifying exclusionary discounts, does not address the question of discrimination because "applying discount rates which are independent of the size of the retailer and in some sense in proportion to its sales efforts, tends to increase, not decrease, competition among retailers, eliminating possible disadvantages that a small retailer would possibly have with respect to a larger one. Such discrimination, at least at first sight, looks pro-competitive."

[17] Court of Appeal, Paris, decision of 21 March 1991, BOCCRF no. 6, 27 March 1991

[18] Comp. Coun. dec. no. 05-D-58 of 3 November 2005 *relating to practices found in the potable water sector in the Ile de France.* The decision was confirmed by the Paris Appeal Court on 26 September 2006 (no. 2005/23649 accessible

Discounts and price discrimination by non dominant companies

In most jurisdictions and certainly at Community level price discrimination is only prohibited when put in place by a dominant firm, *i.e.* dominance being a necessary but not sufficient condition for a prohibition. However in some jurisdictions price discrimination may be prohibited also when put in place by non dominant firms. For example in France article L.442-6 I 1° of the Commercial Code prohibits price discrimination in so far as it concerns a trading partner, it is not justified by a real counterpart and it leads to a competitive advantage or disadvantage:

> "*The following acts committed by any producer, trader, manufacturer or person listed in the trade register render the perpetrator liable and entail the obligation to redress the prejudice caused: Applying to an economic partner, or obtaining from an economic partner, discriminatory prices, terms of payment or terms and conditions of sale or purchase which are not justified by any real counterpart, thus creating, for that trading partner, a competitive disadvantage or advantage.*"

As the French Report suggests, article L.442-6 I 1° is not limited to discounts and "*the discriminations penalised may be very diverse in nature and relate as much to prices as to terms of payment, conditions of sale or even the terms and conditions of sale or purchase.*" As for discounts, the French Report provides a few examples of abusive discounts short of dominance, suggesting that the relevant provisions have been enforced quite regularly in front of the French Courts (and with a fairness approach as to what should be prohibited).

The French law is now undergoing exhaustive reform. Initially, Madame Hagelsteen, the former Chair of the Conseil de la Concurrence, had been assigned by the Economic Minister the task to *"study to what extent laws on anticompetitive practices are adequate and can replace current laws*

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on the Council's Website) and the appeal on point of law against this decision dismissed (Cass. Comm. 20 Nov. 2007, BOCCRF no. 1 of 4 March 2008); see also dec. 99-D-14 of 23 February 1999 *relating to practices implemented by TDF* *on competition restriction practices found in Commercial Code Section IV Book IV."* As the French Report recalls, Madame Hagelsteen concluded in favour of free negotiability of prices, suggesting the repeal of the Commercial Code Article L.442-6, par. I 1°. Such repeal would not have any impact on the prohibition of discriminatory practices when these result from a cartel or abuse of dominant position. Recently, the suggestions of Madame Hagelsteen have been taken up by the French Government and Parliament and the new French competition law (law n° 2008-776 dated 4 august 2008) does no longer contain the reference to discriminations mentioned in article L 442-6 I 1°.

Exclusionary nature of "fidelity discounts"

Discounts can be exclusionary when they do not allow competitors to compete profitably with the discounting dominant firm. However, what mattered in the EC case law was "objective" cost justification of discounts, not whether competitors could profitably replicate them. A competition oriented analysis has been mostly missing in the case law of the Community and national jurisdictions. In general Courts have been silent on the issue of replicability and neither indirect (i.e. when the discounting policy was in place competitors market shares increased substantially), nor direct evidence (i.e. discounted prices were above costs and could therefore be matched by competitors) mattered to exclude that an abuse could be found.

Indirect evidence

The scarce relevance of the existence of (contrary) indirect evidence, can be appreciated by reading an excerpt from the 1999 European Commission decision on Virgin *v* British Airways[19]. Paragraph 107 reads: "*Despite the exclusionary commission schemes, competitors of BA have been able to gain market share from BA since the liberalisation of the United Kingdom air transport markets.*

[19] COMMISSION DECISION of 14 July 1999 relating to a proceeding under Article 82 of the EC Treaty (IV/D-2/34.780 . Virgin/British Airways

This cannot indicate that these schemes have had no effect. It can only be assumed that competitors would have had more success in the absence of these abusive commission schemes". An unrebuttable standard!

The same position can be extrapolated from the responses to the questionnaire contained in most national reports. For example in Hungary the competition Authority stated that "*it is not a pre-condition for finding an infringement under that point for the given competitor to be actually excluded from the market, rather it is sufficient if its market presence is substantially reduced (or is not increased to an extent that it would have increased in the absence of the given conduct") (para 30 of Vj-142/2005 (Invitel)).*

More recently however in Spain, in *Preparados farmacéuticos*[20], a 2007 case, the fact that the complainant had indeed increased its market share during the period in which the conduct had been put in place by the dominant firm was one of the elements which led the authority to reject a claim of predations, suggesting that indirect evidence matters, maybe too much. Indeed the Spanish Report questions the reasoning by the Spanish Competition Authority, suggesting that since the standard for identifying a violation is the "*objective capability of foreclosing competition*", effects are neither a necessary nor a sufficient condition for identifying a violation.

However in most countries the exclusionary effect of fidelity discounts is presumed, the only possible justification being cost savings associated with the discount. Indirect evidence, for example that competitors market shares increased in the period when the fidelity discounts were in place, do not seem to matter. There are some important exceptions. In France the Conseil de la Concurrence went a long way to refine its position on exclusionary abusive discounts and its decisions show the growing importance of economic analysis and of an effect based approach. For example in the TSP/Canal Plus 2005 case evidence that the market shares of the dominant firm increased at the time the abusive discounts were in place was considered important by the Conseil and confirmed by the Paris Court of Appeal[21]. With a similar logic (but with opposite results) in the Royal Canin case the Paris Court of Appeal reversed a decision of the Conseil de la Concurrence because the discounts offered to wholesalers, although potentially they were fidelity enhancing, in practice they did not induce loyalty on the part of retailers, leaving open a number of choices for final consumers[22]. Similarly in the United Kingdom the Office of Fair Trading (OFT) closed the British Airways case[23] because of a lack of evidence that the upfront route specific discounts and the aggregate rebates "*were likely to have a substantial foreclosure effect*".

Direct evidence

In order to assess whether a fidelity discounts strategy is actually exclusionary, competition authorities may need to assess whether the practice is replicable by competitors. Replicability depends on whether matching the pricing strategy of the dominant firm would lead competitors to price below some measure of costs. Therefore, it is necessary to assess whether, as a result of discounts, prices fall below some measure of costs (average variable, average total, incremental or marginal). Indeed in Switzerland, the competition Authority considered abusive the discounting policy of SwissCom-ADSL[24] because it was not justified by costs saving/service offered considerations. However, the Appeals Committee annulled the decision because the competition Authority did not sufficiently establish that the different rebate levels *de facto* excluded Swisscom's competitors from the relevant market. Unfortunately the Appeals Committee did not address directly the issue of replicability or which definition of costs to use. It merely suggested that the Commission did not show that the SwissCom discounting policy was indeed exclusionary.

[20] Decision of the Comisión Nacional de la Competencia (CNC, the new body that substitutes the TDC) of 16 January 2008 in case 628/2007 *Preparados farmacéuticos*, *Fundamentos de Derecho* no. 2.
[21] Paris CA, 15 November 2005, RG n°: 2005/08308
[22] Paris CA, 4 April 2006, Jurisdata n°: 298980.
[23] British Airways case on corporate deals, , closed on April 30 2007 and available at http://www.oft.gov.uk/advice_and_resources/resource_base/ca98/closure/British-Airways2
[24] Recht und Politik des Wettbewerbs 2004/2, pp. 407-448, Swisscom ADSL, at ¶ 142

Furthermore, the assessment of the exclusionary nature of discounts could be made over the costs of the dominant firm, or, alternatively, over the relevant costs of competitors. In general, since a firm (dominant or not) only knows its own costs, the assessment should be carried out with respect to its own costs. An additional argument in favour of the dominant company costs is that, otherwise, there is a great risk of using antitrust enforcement to protect less efficient competitors.

In the 1999 Virgin British Airways case[25] the Commission tried to provide some direct evidence on the exclusionary nature of British Airways discounts granted to travel agents according to predetermined, customized turnover targets. The Commission thesis (which the European Court of Justice upheld in 2007) was that BA discounts led to very strong increases in the commissions an aggressive competitor might be obliged to provide to travel agents so as to make them indifferent to the BA offer. The Commission (paragraph 30 of the decision) showed that a new entrant wishing to compete away 1 percent of the BA market would have to reduce its price by 17.4% (in order to compensate the travel agent for the lost BA commissions). Because of this 17.4% price reduction, the Commission presumed that competing airlines did not have the ability to profitably match BA discounts. This is not necessarily realistic, considering that, irrespective of the discounts, Virgin was able to enter the market profitably and substantially increase its market shares.

What I mean is that indirect evidence that the practice was not prima facie exclusionary should induce great caution in the conclusions an antitrust Authority could reach. To the contrary there is no evidence in the decision whether a 17.4% price reduction would drive prices below costs. Furthermore, the Commission's analysis of the way travel agents operate was quite abstract and incomplete. In particular, the exclusionary nature of target discounts was assumed without an analysis of the way travel agents actually compete in the market and whether consumers were actually misled by travel agents who withheld less-expensive alternatives or strongly discounted BA tickets in order to achieve the BA target. All these price undercuttings are simply presumed. Moreover, there was no analysis of the extent to which consumers directly informed themselves of competing prices by contacting the airlines directly themselves and were therefore not captive to the suggestions of travel agents.

A similar approach to the one adopted by the Commission in Virgin British Airways was adopted both by the Spanish and by the Italian Competition Authorities with respect of the commissions' schemes that Iberia[26] and Alitalia[27] applied to travel agents for the sale of its tickets. Like the Commission also the Italian and Spanish authorities calculated the reduction of prices needed to compensate a travel agent for the lost Iberia and Alitalia discounts. Like in the Commission case, whether such a reduction of prices would lead a competitor to price below costs is not even considered[28].

After the Virgin *v* British Airways case, the Commission outlined its policy on commissions paid by airlines to travel agents[29]. First, the Commission required that discounts be cost-justified. Moreover, discounts had to increase linearly, they could not be retroactive, and travel agents had to be free to sell the tickets of all airlines. There was no reference in the list of prohibited discounting practices that addressed the effect the allegedly abusive discounts might have on competition or the ability of competitors to match them. The only flexibility that the Commission seemed to grant, and that was clearly related to the practice's effect on the ability of competitors to compete, was to limit to six months the period during which target rebates should be calculated.

More recently in the Prokent/Tomra 2006 decision[30], a decision that was taken two months after the article 82 discussion paper was published, the Commission continues on the same line, suggesting on paragraph 329 that it is not "*necessary to demonstrate that the rebate scheme has the drastic*

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[25] Commission Decision 2000/74/EC, Virgin/British Airways, 2000 O.J. (L 30) 1

[26] Tribunal de la Competencia, RESOLUCIÓN (Exp. R 514/01, IBERIA), available at http://www.cncompetencia.es/html/resoluciones/2002/1638.htm

[27] Italian Competition Authority, Case A291 Assoviaggi/Alitalia, decision n. 9693 of 27 June 2001, published in Bulletin n. 26/01.

[28] It is very interesting that these three decisions (on the same violation) led to very different sanctions: 26.9 million EUR to Alitalia, 6.8 million EUR to British Airways, 700 000 EUR to Iberia.

[29] See J. Finnegan, Commission sets out its policy on commissions paid by airlines to travel agents, 3 COMP. POL'Y NEWSL. 23 (1999).

[30] Case Comp/e-1/38.113 – Prokent-Tomra, Bruxelles 29/3/06

effect that the other party could not afford to take the risk of buying from a competitor as it would otherwise incur in losses". Indeed in the 159 page decision, the Commission nowhere shows that matching the discounting policy by a competitor would lead him to price below cost. Indirect evidence and intent is what really matters.

Among the reporting jurisdiction, in the United Kingdom there is some (indirect) evidence that an effect based approach is more likely. In the 2004 draft competition law guidelines on assessment of conduct[31] the OFT suggests that "(*f)idelity rebates may be abusive where they lead to foreclosure effects. It is the 'loyalty inducing effect' of a fidelity rebate that generally raises potential competition concerns. However, even where a discount scheme adopted by a dominant undertaking has a loyalty inducing effect, the scheme would not be found abusive if it did not (or was not likely to) harm competition."*

The 2005 DG Competition discussion paper on exclusionary abuses

In the DG Competition discussion paper on exclusionary abuses, the equally efficient competitor test is suggested as the standard to be applied in the evaluation of the abusive character of discounts. Like in Heimler (2005), the discussion paper suggests that the calculation of the below-cost character of discounts is made with respect to the relevant range of sales (a small but significant increase in the sales of competitors) and refers to the price-cost margin of the dominant firm, so as to ensure that exclusion is assessed with respect to an equally efficient competitor. As in predation, if discounts lead to prices below (marginal) costs, the foreclosure of an equally efficient competitor is presumed, there is no need to look for efficiencies and a reduction of consumer welfare can also be presumed. The methodology presented in the discussion paper avoids the pitfalls in both the Michelin II and the Virgin *v* British Airways cases.

[31] See http://www.oft.gov.uk/advice_and_resources/publications/guidance/competition-act/oft414a

As for answering the question as to whether above cost rebates could be considered abusive, there is no case law that could assist us. Heimler (2005) provides a tentative answer in the concluding section of his paper:

> *"A final question … is whether antitrust enforcement can really be based on fine-tuning arguments—for example, whether it is abusive to exclude a less efficient competitor because, in the future, he may become more efficient. The answer is a reasoned, "yes." In very special circumstances—those where there is direct and strong evidence of the near-future efficiencies—the assessment of the exclusionary nature of rebates should be made with respect to the average incremental cost of the dominant firm associated with the small but significant increase in sales of the competitor."*

Similarly in paragraph 165 of the discussion paper on the application of Article 82 of the Treaty to exclusionary abuses Dg Competition writes:

> *In case it is clearly established that the effective price is above ATC, it is unlikely that the Commission will conclude that a market distorting foreclosure effect results. However, exceptionally this may be concluded, for instance if it is established that the dominant company operates in a market where it has certain non-replicable advantages and that the rebate system is likely to exclude entrants that would help the competitive situation on the market to improve. In such a situation the dominant company could prevent entry or eliminate entrants by using rebates while the effective price stays above its own ATC. For such rebates to be assessed as abusive additional elements will have to be shown, in this case that the entrant will only be less efficient because of these non-replicable advantages.*

What this means is that in exceptional circumstances above cost price discounts may indeed be abusive.

Conclusions

The European antitrust tradition is mostly based on fairness considerations. Indeed the case law of the European Courts suggests that the only proper justification for discounts is some objective measure of the cost savings associated with the corresponding level of sales. Otherwise, exclusionary effects are presumed, irrespective of any evidence based on replicability considerations. Market mechanisms and competition have mostly been ignored.

The major problem with the economic analysis of discounts is that that the possible abuse corresponds to situations where the dominant firm is globally profitable and where matching the discounting practice has or will lead an equally efficient competitor to price below cost—implying that incremental pricing is also below cost for the dominant firm. The problem here is that the standards cannot be the same as those in predation: first of all there is a need to estimate the quantities over which to calculate the price cost margins; second there is a need to identify a measure of costs; finally recoupment is not an issue because it occurs in the same time period with respect to infra marginal units.

Heimler (2005) identifies a checklist for the identification of abusive discounts that continues to be valid:

1) Matching a dominant firm discounts by an equally efficient competitor leads to prices below costs;

2) the calculation of the below-cost character of discounts is made with respect to a small but significant increase in sales, reference has to be made to the price-cost margin of the dominant firm to ensure that exclusion is assessed with respect to an equally efficient competitor.

3) The outcome of the replicability assessment depends on the definition of the sales of the dominant firm which are benchmarked against the relevant measure of costs (total yearly output or some other range). For example, if firms compete for the total demand of a given

customer, rivalry occurs at the beginning of the reference period and discounts cannot be predatory in so far as they lead to total revenues above costs. However, if there are asymmetries among firms, in the sense that only the dominant firm can supply total demand by individual customers and its competitors either do not have the capacity to do so, or do not have enough reputation so as to satisfy all potential customers, or supply only a limited part of the portfolio of products of the dominant firm, then the relevant measure of sales has to be identified.

4) In the case of bundled discounts (where the firm is dominant only over some of the products it sells) the abusive nature of discounts should be assessed by allocating the full discounts on the products over which the firm faces competition.

5) Appropriate consideration should be given to the fact that in a pluralistic market structure (where the number of competitors is greater than two), expansion or new entry is limited by rivalry from all market participants, not just from the dominant firm. In this respect, the record of entry in the industry and the relative movements of market share from year to year should be given proper consideration, in the sense that if there is profitable and extensive entry in the industry in the course of the years when the discounting practice was in place, the practice itself may not be exclusionary.

In all of the cases that have been surveyed in this Report, there is no evidence that matching the discount of the dominant firm has or will lead competitors to price below cost. The evidence provided is mainly on the absence of cost savings associated to discounts. However, the cost-saving argument is not taken to its logical conclusion, and for example reductions of uncertainty of production that discounts may achieve is not considered as an "objective" cost saving.

An important point worth mentioning is whether a merger should be prohibited on the grounds that there is the potential for such discounting practices to be put in place. The answer is "no." Indeed, in its judgment annulling the Commission's prohibition of the Tetra Laval/Sidel merger[32], the CFI stated that the Commission, in assessing the effects of a merger, is required to assess whether the prohibition of abusive conduct makes discounting practices less likely.

A final question is whether antitrust enforcement can really be based on fine-tuning arguments—for example, whether it is abusive to exclude a less efficient competitor because, in the future, he may become more efficient. The answer is a reasoned, "yes." In very special circumstances—those where there is direct and strong evidence of the near-future efficiencies—the assessment of the exclusionary nature of rebates should be made with respect to the average incremental cost of the dominant firm associated with the small but significant increase in sales of the competitor.

[32] Case T-5/02, Tetra Laval v. Commission, 2002 E.C.R. II-4382, declaring void Commission Decision 2004/103/EC, Tetra Laval/Sidel, 2004 O.J. (L 38) 1, appeals to the ECJ are pending as Cases C-12/03 and C-13/03, Commission v. Tetra Laval; Case T-310/01

Appendix

FIDELITY DISCOUNTS AND REBATES NOT JUSTIFIED BY THE COSTS : IN WHICH CASES SHOULD A DOMINANT ENTERPRISE BE FORBIDDEN SUCH PRATICES?

QUESTIONNAIRE TO NATIONAL RAPPORTEURS

1) Definition of fidelity discounts

The question refers to fidelity discounts. "Fidelity" identifies a sub category of discounts, intended to provide either implicit or explicit compensation for loyalty (you buy only from me). In theory, "fidelity" discounts should be distinguishable from "quantity" discounts, the other sub category of discounts, where a seller provides compensation for large purchases. In practice, the distinction between "fidelity" and "quantity" discounts is much less clear, largely indirect and based on the "objective" justification of the provided discounts. If discounts are objectively justified (strictly cost based) then discount enhances fidelity only indirectly, since the discount passes down to customers the cost reductions originating from the purchase. In such cases discounts are unlikely to be considered fidelity discounts (see also point 2)

Are you aware of any decision/judgement in your jurisdiction providing a definition of "fidelity" discounts as opposed to other types of discounts? Please describe

2) Cost justification

The problem is that the a cost justification is presumed whenever discounts are directly proportional to quantities purchased in a given period (usually a year). This is not always appropriate. A cost justification may exist if a single order is placed at the beginning of the production period, while deliveries are distributed in the course of the year (reduction of demand uncertainty). A cost justification may also exist if delivery of all quantities purchased occurs in a single instalment (reduction of transportation costs). On the other hand, if the quantity that triggers a discount is achieved by unplanned purchases made in the course of a year, a cost justification is much more difficult to identify.

Are you aware of any decision/judgement in your jurisdiction discussing evidence of the cost justification underlying a discounting policy? Please describe

3) Price discrimination

"Fidelity" discounts are meant to compensate exclusive purchasing patterns. Therefore "fidelity" discounts are inherently discriminatory. A purchase of 100 units may trigger a discount if the supplier covers all the needs of the acquirer for that particular product, otherwise the acquirer may not receive any discount (and pay a higher price than its competitors). This implies that acquirers of the same quantities may face different prices.

In your jurisdiction may price discrimination by a dominant firm violate antitrust law? If so, how is this discrimination defined? In particular, is this discrimination prohibited per se or only inasmuch as it actually distorts competition in the market? Please describe

In most jurisdiction price discrimination may only be prohibited when put in place by a dominant firm, *i.e.* dominance being a necessary but not sufficient condition for a prohibition. However in some jurisdictions price discrimination may be prohibited also when put in place by non dominant firms.

Are there rules in your jurisdiction that prohibit price discrimination irrespective of the market power of the firm involved? Can you briefly describe these rules and discuss how they are interpreted?

4) Exclusionary nature of "fidelity discounts"

Discounts can be exclusionary when they do not allow competitors to profitably compete with the discounting dominant firm. However there are a number of problems associated with this exclusion. The first one relates to the burden of proof. Is indirect evidence (e.g. the fact that competitors market shares were not affected) sufficient to rule out any exclusionary effect?

In your jurisdiction is indirect evidence that market shares of competitors (and especially market shares of complainants) were not affected by the discounting policy sufficient to rule out its allegedly exclusionary effect? Please describe

In order to assess whether a fidelity discounts strategy is actually exclusionary, competition authorities may need to assess whether the practice is replicable by competitors. Replicability depends on whether matching the pricing strategy of the dominant firm would lead competitors to price below some measure of costs. Therefore, it is necessary to assess whether, as a result of discounts, prices fall below some measure of costs (average variable, average total, incremental or marginal). Furthermore, as for predatory prices, the assessment could be made over the cost of the dominant firm, or, alternatively, over the relevant costs of competitors.

In your jurisdiction is the exclusionary nature of discounts proved through a comparison of costs and revenues? If not, how else is such exclusion assessed?

Should your jurisdiction perform a comparison of costs and revenues, what is the definition of costs that is used, average variable, average total, incremental or marginal? Please describe

Furthermore in your jurisdiction are the relevant costs over which the comparison is undertaken the costs of the dominant firm or the cost of the excluded competitor? In any case are there instances where an above costs abuse was identified in your jurisdiction? Please describe

The outcome of the replicability assessment depends also on the definition of the sales of the dominant firm which are benchmarked against the relevant measure of costs (total yearly output or some other range). For example, if firms compete for the total demand of a given customer, rivalry occurs at the beginning of the reference period and discounts cannot be predatory in so far as they lead to total revenues above costs. However, if there are asymmetries among firms, in the sense that only the dominant firm can supply total demand by individual customers and its competitors either do not have the capacity to do so, do not have enough reputation so as to satisfy all potential customers, or supply only a limited part of the portfolio of products of the dominant firm, then the relevant measure of sales has to be identified.

In your jurisdiction what is the relevant output over which the exclusionary effect of discounts is calculated and, in the case of bundled discounts, which is the relevant revenue over which the exclusionary effect of discounts is calculated ? Please describe

5) Justifications for exclusionary discounting policy

Appropriate consideration might be given to the fact that in a pluralistic market structure (where the number of competitors is greater than two), expansion or new entry is limited by rivalry from all market participants, not just from the dominant firm. In this respect, the record of entry in the industry and the relative movements of market share from year to year should be given proper consideration, in the sense that if there is profitable and extensive entry in the industry in the course of the years practice was in place, the practice itself may not be as exclusionary as expected.

Once a discounting policy is proved to be exclusionary, are there instances where the competition authority accepts justifications by the dominant firm as for the legality of the discounting strategy and if so which justifications have a greater probability of being accepted? Are these justifications relevant for the identification of the abuse, for assessing the level of a possible sanction or for both? Please describe.