RBB Brief 21

RBB Economics

Tomra: rolling back form-based analysis of rebates?

The Tomra Article 82 Decision is the first to have been issued since DG COMP's much-debated Discussion Paper on Article 82 was published in December 2005 ("the Discussion Paper").[1] A recent article in the DG COMP Newsletter ("the Newsletter") by members of the Commission case team states that the decision marks an important step towards the envisaged reform of Article 82 enforcement.[2] In this Brief we consider the Commission's approach to Tomra's rollback rebates and assess the implications for the brave new world of effects-based analysis.

Tomra – a brief summary of the facts

Tomra was found to be a dominant supplier of reverse vending machines (used by supermarkets to collect empty beverage containers from, and return deposits to, consumers). Tomra enjoyed market shares of 80% or more in various national markets, although the Newsletter notes that entry to this market "is neither particularly difficult, nor exceedingly costly".

Tomra was found to have engaged in a number of exclusionary pricing practices aimed at denying rival suppliers access to the market, and was fined €24m. Chief among the abuses were a series of rollback rebates. Just as it had done in previous cases against BA, Michelin and others, the Commission ruled that the incentive properties of these discount schemes excluded competition. However, in contrast to the more formalistic approach that has been used in previous cases, in the Tomra case the Commission states that it backed up its conclusion with an economic analysis of the effects of the rollback rebate scheme.

Rollback rebates

Figure 1 below shows a stylised example of a rollback rebate scheme offered by a hypothetical dominant firm, Domco, in which a customer pays the list price of €1 per unit for the first 99 units but then qualifies for a 10% discount on all purchases as soon as the 100th unit is bought. As the customer increases purchases from 99 to the target level of 100 units, therefore, the supplier's total revenue *falls* from €99 to €90 – it is as if Domco pays the customer a lump sum of €9 to take the 100th unit.

Figure 1: Rollback rebate
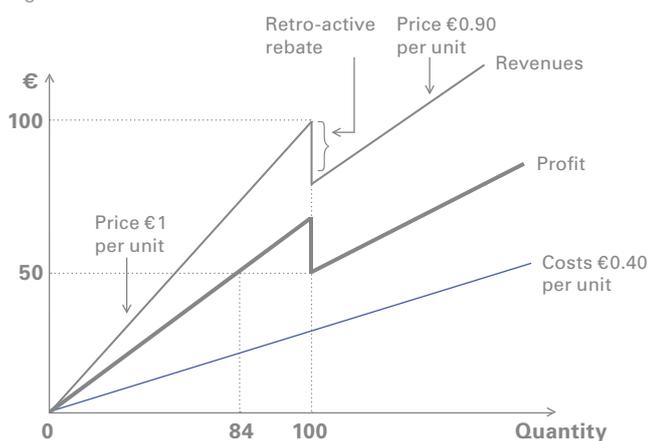
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For the purpose of this paper, we assume that the question of how to measure the relevant cost is uncontroversial. In practice the appropriate measure of cost is a hotly debated topic beyond the scope of this Brief.

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See Section 7.2.2.1 of Discussion Paper, pp 44–45. In our example, this suction effect arises where the customer increases its purchases from 84 or more units to the 100 units at which the rebate becomes payable. Domco's profit is above €50 if purchases are between 84 and 100 units, but falls back to €50 as the customer buys the 100th unit.

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We say "might" because profit sacrifice occurs only if the customer would have been willing to buy more than 84 units at the non-discounted price. (In technical terms, implied pricing below cost might be an "out-of-equilibrium offer", i.e. an offer that the supplier knows will never be accepted.)

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This presumption is supported by some readings of the case law, such as the ECJ judgment on the Akzo Article 82 case.

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See for example, para 110 of the Discussion Paper.

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For a detailed discussion of the analysis of rollback rebates see chapters 4 and 5 of RBB's report for the Office of Fair Trading, "Selective price cuts and fidelity rebates" July 2005 ("the RBB rebates report").

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By "price" we mean "average revenue per unit sold." In practice, the rival might be expected to offer non-linear prices of its own (e.g. charging a different price for the first 20 units than for the 21st unit and beyond).

Figure 1 also shows how costs and profits vary with volumes sold. We assume that Domco's relevant costs of supply are simply €0.40 per unit.[3] Figure 1 shows that Domco's profit (defined as revenues minus costs of supply) is always positive. However, since the unit cost of production is constant, the rollback rebate cannot be "cost-related" in the strict sense. This creates a range – where the so-called "suction effect" applies – in which the supplier's profits actually fall as its sales to the customer increase.[4] In short, Figure 1 shows a discount scheme that is always and everywhere profitable for the supplier but where incremental sales over some parts of the scheme might imply profit sacrifice.[5]

Some presume that profit sacrifice can be explained only by a strategic anti-competitive motivation to exclude rivals and protect monopoly.[6] However, rollback rebates are commonly employed by firms that are not dominant and there are a number of reasons why apparently loss making behaviour can be pro-competitive.[7] Ultimately the (difficult) challenge for an effects-based analysis is to determine whether a given rollback rebate is more likely to give rise to harmful exclusionary effects than to beneficial pro-competitive effects.[8] So how did the Commission address this challenge in the Tomra decision?

Tomra's economic defence

Judging from the Newsletter, Tomra mounted an economic defence of its rebates by relying on an analysis of the (average) price a rival supplier must set to compete with the rollback rebate.[9] Suppose, for example, that the rebate scheme described in Figure 1 was offered by Domco to a customer whose total needs amounted to 120 units of the product. Assume also, for simplicity, that the rival's product is identical in quality to that of the dominant firm.

By buying all 120 units from Domco at the discounted price of €0.90, the customer could meet its requirements at a total outlay of €108. Figure 2 describes the "compensating" price the rival would need to offer for different volumes of its product in order to leave the buyer's total outlay at this €108 level – i.e. to make the customer indifferent between Domco's offer and that of the rival.

Figure 2: Rival's "compensating" price
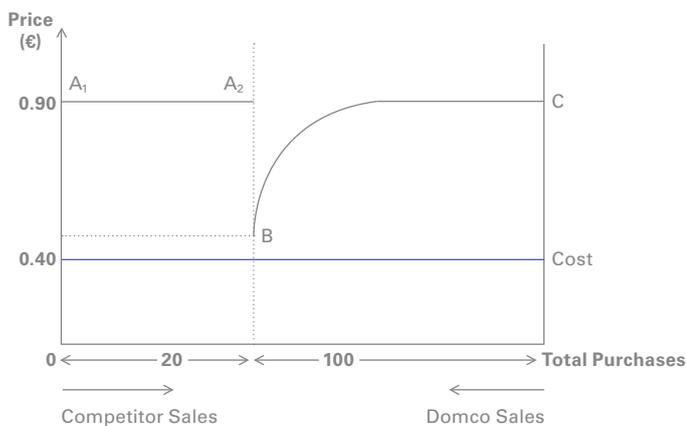
If the rival firm focuses only on contesting the 20 units that lie above the target threshold (the range A_1–A_2), it must beat Domco's €0.90 price in order to win these volumes.

Taking the other extreme (point C), if the rival is able to tender to supply the whole of the customer's requirements, then the rollback scheme is no different from an across the board price cut. Again, therefore, the rival simply needs to beat that price of €0.90 in order to win all the customer's business from Domco.

Between these extremes (the curved line in Figure 2 from B to C), the rival firm is obliged to offer a price below €0.90. As soon as the customer buys more than 20 units from the rival, it misses Domco's target and loses its entitlement to the rollback rebate. The rival must therefore compensate the buyer by lowering its price. The fewer units the rival sells above 20, the lower its average price must be to make up for the lost "lump sum" discount. In the worst case scenario, where the rival supplies 21 units and Domco supplies the other 99 units required by the customer, the rival would have to cut its price to just under €0.43 per unit in order to leave the customer no worse off.[10]

Tomra's economic defence appears to have rested on the proposition that, as in our illustration, an equally efficient rival (i.e. one with Domco's cost base) could cover its costs even in the "worst case" scenario in which it sells just enough to disqualify the customer from meeting Domco's rebate. If that is the case, Tomra asked, how can the scheme be deemed to have exclusionary effects?

The Commission's view

The Newsletter explains why the Commission rejected this defence. The authors acknowledge that the rival could profitably sell 21 units in the scenario painted here. However, they assert that no rational supplier would choose to operate at this level because the 21st unit of sales would make the rival much worse off than if it remained at 20 units. Specifically, they state that Tomra's argument "violates individual rationality … As a result, the Commission was able to maintain its findings concerning likely foreclosure effects".[11]

The Commission appears, therefore, to have based its decision on the fact that Tomra's target rebate forces the rival to engage in an "unnatural" form of competition that requires it to concede profit. However, it is inevitable that an analysis of the competitor price as set out in Figure 2 above will simply mirror the incentive properties of the dominant firm's rebate scheme. If that scheme involves some profit sacrifice, then any rival pricing scheme must also contain a discontinuity at which an equal and opposite profit sacrifice occurs in order to neutralise its effects. Hence, an approach that focuses solely on the point where the discontinuity occurs amounts to a blanket assertion that rollback rebates are unlawful simply because they imply negative prices in the range just prior to the target.

The bigger picture – assessing the requirements of an effects-based exclusion theory

An effects-based approach must go beyond a myopic analysis of incentives just prior to the point in a rebate scheme at which the target is reached. It must embrace a broader assessment of how the business conduct in question is likely to have an adverse effect on the competitive process and on consumers. The starting point should be some relatively straightforward screening questions to assess whether foreclosure is feasible.[12]

First, we need to establish the likelihood that the conduct in question will result in an exclusionary outcome. A useful starting point is to assess whether alternative routes to market exist that would allow the rival to attain an efficient scale of production.

[10]

The 99 units from Domco would cost €99, leaving just €9 left to pay for the rival's 21 units – an average price of €0.43.

[11]

See Newsletter, p. 24.

[12]

See the RBB rebates report for further details.

Foreclosure is a market-wide phenomenon. Assessing foreclosure by reference to the impact on individual customers works only if those customers are representative of the market as a whole, or if they are strategically important for some other reason.[13] If the rebates in question are only offered to selected customers, an analysis that focused purely on the rival's options to win sales from customers that already benefited from the dominant firm's rebates would overstate potential foreclosure effects.

In the Tomra case, the Newsletter indicates that on average only 32% of demand was "foreclosed" to competitors by the rebates in question. If the other 68% of demand was readily contestable by rivals, that would cast doubts on whether the Commission has met its own Discussion Paper criteria on the likely existence of an anti-competitive effect.[14]

Second, dominant firms are more likely to benefit from the leverage effects associated with rollback rebates if they can rely on a substantial captive base of sales.[15] Foreclosure becomes a serious problem only if the purchaser is substantially locked-in to buying a sufficiently high share of its requirements from the dominant firm that the rival is denied the ability to achieve an efficient scale (e.g. because the scheme implies below cost pricing on the "contestable sales"). The Newsletter refers to the possibility that capacity constraints and buyer risk-aversion might limit the ability of Tomra's rivals to contest high shares of any customer's business, but this point is not fully developed.

A captive base should not be assumed to exist simply because a firm is dominant. Nonetheless, where the existence of a captive base of sales can be demonstrated, it can be a crucial factor in determining the competitive effects of a rollback rebate scheme. For instance, in terms of our example, if the captive base was 84 units or more, the scheme would imply below cost pricing for the remaining contestable units up to the target. On the other hand, suppose that our customer's dependence on Domco was set at a much lower level, such that an equally efficient rival could realistically expect to sell 37 or more units to the customer in question. The rival would make more profit by doing so than if it chose to sell just 20 units because the margins on the incremental sales eventually outweigh the cost of having to compensate the customer for missing out on Domco's rebate.[16] As in many business situations, therefore, the immediate costs a rival would bear in pushing sales just beyond 20 units might well be compensated by the profits to be gained from expansion substantially beyond that level.[17] The fact that a rival would incur some profit sacrifice in moving from 20 to 21 units does not establish that it would be denied profitable access to the market.

Conclusions

The Tomra decision has been portrayed as a case in which the Commission has applied an effects-based approach to rebates. However, from the description of the case in the Newsletter it is unclear whether the Commission has satisfied the tests for foreclosure that were proposed in the Article 82 Discussion Paper. The specific reasons given in the Newsletter for rejection of Tomra's defence appear to rely on a very localised result that does little more than re-state the traditional form-based objections to rebates.

Perhaps the published version of the Decision will reveal a richer and more convincing foreclosure story. If not, this would be a disappointing start to the promised new era of effects-based analysis.