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Leveraging Non-Contestability: Exclusive Dealing and Rebates under the Commission's Article 82 Guidance

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I. INTRODUCTION

Rebates was always the hardest exclusionary abuse. Navigating through the DG Competition Staff Discussion Paper of 2005, the retroactive rebate section felt like Ellen MacArthur's description of sailing fast in the Southern Ocean at night ("lashing rain...no headlights...no windscreen...no roof"). The debate has deepened, notably with differing perspectives laid out in the U.S. Department of Justice (DOJ)'s own Single-Firm Conduct report of September 2008, and in the inter-US-agency "dialogue" which followed. But we are still a long way from any international consensus. The best that can be said is we now understand better the different strands of thinking. And in Europe we do at least now, with the Commission's new Guidance, have a coherent approach. Whether it is going to work in practice is another matter.

In this short article I propose initially to summarize, in the most succinct way I can, the EC approach to rebates and exclusive dealing, and the DOJ approach. Then I will tackle the subject through a series of propositions:

- First, that the EC has shifted in its conditional rebates analysis decisively to a test based on leveraging non-contestability;

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- Second, that the EC seeks to work in the doctrine of the “as efficient competitor” by nominally loading the discount onto the contestable portion of demand—and this approach has some support in the United States;
- Third, that the EC has watered down, through the fitting (or retrofitting) of several safety valves, its test for when rebates will be exclusionary;
- Fourth, that we are moving, slowly in Europe, towards a common predatory standard for exclusionary price behavior—but until the Commission properly addresses what that standard is we will not have a standard at all;
- Fifth, that there remain a number of other differences between EC and U.S. policy (or indeed the policies of other jurisdictions) where the EC has yet to properly elucidate its position; and
- Sixth, that exclusive dealing, which we always saw as the extreme version of a rebate scheme, is in many respects—paradoxically—easier to deal with, and seems to have drawn more international consensus.

II. EC AND U.S. POLICY: A SUMMARY

The EC position is as follows (bear in mind, of course, that we are only talking about dominant firms). The Commission will be inclined to oppose exclusive dealing where competitors (i) are not able to compete for the full demand of individual customers and (ii) exercise an important competitive constraint—and particularly where the obligation is long in duration or the dominant firm is an unavoidable trading partner. So far as rebates are concerned, the issue is whether they foreclose actual or potential rivals.

And the way they would do so is by using the “non-contestable” portion of a customer's demand—the part each individual customer would buy from the dominant firm in any event—“as leverage to decrease the price to be paid for the ‘contestable’ portion of demand (i.e. the amount for which the customer may prefer and be able to find substitutes)” (Guidance §38).

The form of rebate that has attracted all the attention is “retroactive” or “dollar one” rebates—that is to say, discounts applied back across the whole of a customer's purchases in the reference period (e.g. one year) once the target is reached, as opposed to merely on purchases above the target. The essential analysis which the Commission will use is: (i) to assess the portion of demand that is contestable; (ii) to nominally load the discount onto it to give an “effective price;” and (iii) to see if efficient rivals can compete at that price, with a strong presumption that they can if it is above the dominant firm's long-run average incremental cost (“LRAIC”).

The United States has proceeded from a different place. The DOJ puts exclusive dealing in a different chapter of its report from rebates, not even contiguous with it (refusal to deal comes in between). This reflects the relative richness of the jurisprudence: exclusive dealing has been the subject of a number of Supreme Court and several Courts of Appeals judgments; rebates have not. The DOJ's approach is to “focus [] on whether the exclusive dealing allows a firm to acquire or maintain monopoly power” and, if it does, to oppose the conduct only if the harm is substantially disproportionate to the consumer benefits (or if there are no such benefits) (Single Firm Conduct report, p136;

p140). A safe harbor is declared if less than 30 percent of the market is foreclosed (p141). For bundled rebates, the test is effectively the same: the first limb typically being made out through actual or imminent exit of rivals from the market and the second limb again weighing the benefits and requiring disproportionality for intervention (p105). For single product loyalty discounts, the DOJ reports the different views of panelists and ultimately settles on a predatory-pricing approach (with a price-cost safe harbor), stating its skepticism regarding the administrability of contestability or efficient scale measures.

These DOJ conclusions were criticized sharply in the statement of Federal Trade Commission (“FTC”) Commissioners Harbour, Liebowitz, and Rosch (issued to coincide with publication of the DOJ report and available on the FTC website). They argue that the price-cost safe harbor, combined with what they regard as an over-emphasis on market exit, could “permit a firm with monopoly or near-monopoly power to foreclose a weaker rival from the minimum viable scale it would need to constrain the exercise of monopoly power” (pp6-7, Statement). That the two U.S. federal antitrust agencies should disagree so markedly and so publicly demonstrates how far we are from any kind of consensus in this area.

III. LEVERAGING NON-CONTESTABILITY

The contestability approach marks a shift in position since the Staff Discussion Paper. While it featured in that paper (§153), the thrust was on working out the “commercially viable share” for the rival, and the discount was loaded not onto the “contestable” share but onto the commercially viable share. The two things are distinct:

the latter focuses on the rival from a *supply* perspective; the former views the problem from a *demand* perspective. In practice this may not make much difference: if the subset of the individual customer's needs is not viable for a rival then it is hardly likely to be contestable. But it is somewhat surprising that so important an issue as a shift in one of the two or three main measures the Commission will use to judge legality is made without explanation.

Of the two, the demand perspective, being more consumer-focused, is probably the better. The real issue is whether these measures are going to be workable in practice. Which regulator or judge is qualified to apply them, exactly? The answer is it will fall to economic experts and consumer evidence. But the Commission is not very good at believing in consumer “evidence” and economists are very good at disagreeing with one another.

IV. LOADING THE DISCOUNT

The discount in a retroactive scheme is expressed to be granted back over the whole of the customer's purchases in the reference period. But what the Commission has always done—at least in the ten years since its decision in *British Airways* (COMP 2000/74/EC)—is nominally to load the discount onto a sub-portion of the customer's purchases. This is the portion that used to be the commercially-viable share and is now the contestable share, as discussed above. In fact, before it was the commercially-viable share it was something even smaller, seemingly defined in such a way as to cause maximum shock in terms of the level of discount the competitor would have to give in

order to compete for that segment of demand. So we have come a long way. But the principle of loading the discount onto something smaller than the whole reference period's purchases must be right. Once it is recognized that competition will take place for sub-sets of individual customers' demand, then if we are to have any kind of quantitative-based benchmark as part of the analysis we need to do that. It is noteworthy in this context that U.S. jurisprudence has recognized this (see DOJ Single Firm Conduct report, p93, discussing the *Virgin vs British Airways* court's citation of *Ortho* for a similar proposition).

V. RETROFITTING SAFETY VALVES TO THE REBATES TEST

Another striking feature of the Guidance is the way the bar for intervention has been effectively raised through the introduction of a number of “safety valves” allowing the Commission an exit route from opposition to a scheme. I count five. First, there is a lower and more nuanced set of cost bars: in the Discussion Paper the effective price had to be above average total cost (“ATC”) to be legal (Discussion Paper §156); in the Guidance, provided it is above average avoidable cost (“AAC”) other factors are needed to justify intervention (Guidance §43). Second, the safe harbor has expanded to allow firms to price down to LRAIC in place of ATC (Guidance §42). Third, between the upper (LRAIC) and lower (AAC) bars of the “hard look” band it must also be shown that competitors do not have “counterstrategies” at their disposal (Guidance §43). Fourth, all of the above is only one aspect to be “integrated in the general assessment” (Guidance §44). Fifth, the Commission recognizes repeatedly the “margin for error” and “varying

degrees of precision” of the quantitative analysis implying a need for a scheme to be well clear of the line for it to have the confidence to intervene (Guidance §40 and footnote 29).

VI. TOWARDS A PREDATORY STANDARD?

Standing back, it is impossible to look at rebates without looking at exclusionary behavior as a whole, at least pricing behavior. Following the Court of First Instance appeals against the *British Airways* (T-219/99 [2003] ECR II – 5917) and *Michelin* (T-203/01 [2003] ECR II-4071) Commission decisions rebates became a kind of bellwether for the Commission's approach to exclusionary abuse. This was somewhat ironic since the judgments borrowed heavily from an article by a senior Commission official which was confined to rebates. But passages in the judgments were drafted that way, and the European Court of Justice followed a similar line in the *British Airways* final appeal (C-95/04P [2007] ECR I-2331).

The Commission's new rebates policy fits within the general rubric of its Guidance—to require the showing of actual or likely “anti-competitive foreclosure” i.e. restriction of access of rivals to the market. It fits with the general “as efficient competitor” approach because the focus is on the dominant firm covering its own costs. And this is exactly what is at the heart of the Commission's approach to both predatory pricing and margin squeeze.

So far so good. But there is an elephant in the room which the Commission and courts have so far largely ignored. The problem is what we mean by “as efficient

competitor.” The dominant firm and its rivals will have different cost curves. In many instances the dominant firm's cost level may be lower overall than that of the rivals—reflecting, for example, scale economies—even though for any given output level its cost curve lies always above that of the rivals. Is the test a relative one or an absolute one? If the rival with the more efficient cost curve is less far down his own cost curve than the dominant firm is down the dominant firm's curve, and is above the cost of the dominant firm in absolute terms, is the rival more or less efficient?”¹ Clearly the test is hopeless without a clear answer to this question.

The striking thing is we do not have a clear answer to this question. The cases on margin squeeze, dealing with rather more extreme situations which are really about refusal to supply (but that is for another paper) do not even begin to address it. The Commission does begin, but it does not follow through—let alone conclude, (see, for example, Discussion Paper §129 and now Guidance §23 (perhaps the most carefully crafted paragraph in the Guidance paper) on the scope for intervention to protect “less efficient competitors).”

VII. FURTHER EC/U.S. DIFFERENCES REQUIRING ELUCIDATION FROM THE COMMISSION

In April 2008, the Unilateral Conduct Working Group of the International Competition Network presented a Report on Single Branding/Exclusive Dealing in Kyoto. The report reveals a number of additional stark areas of difference between the EC and the United States in this area, differences which the EC has not so far properly explained:

¹I am grateful to Mark Williams and Paul Hofer of NERA who first explained this point to me.

- There is the question as to whether it is relevant if the non-dominant party *requests* the exclusive arrangement. Nineteen out of twenty-five jurisdictions asked—including the European Commission—said no. The U.S. agencies said yes, it increases the likelihood that the non-dominant firm is obtaining pro-competitive efficiencies (pp10-11). We should note here that the EC's professed approach differs from what it actually did in the *Coca-Cola* Article 9 settlement (COMP/39.116, 22 June 2005) where it allowed participation in public and private tenders for exclusivity within certain limits (see section D.2 of the Undertakings in that case).
- There is the question of safe harbors. Here the position is unclear on both sides of the Atlantic. The ICN paper refers to U.S. case law as showing that “foreclosure levels below 50 percent rarely lead to liability” (p17). The DOJ Single Conduct report adopts a 30 percent safe harbor (p141)—which in turn is criticized in the Statement of the three FTC commissioners as part of a “multi-layered protective screen for firms with monopoly or near-monopoly power.” The EC's position on safe harbors is unclear, although the 30 percent threshold finds some support in the *Distrigaz* settlement (Case COMP B-1/37966, 11 October 2007).
- Finally, there is the meeting competition defense. Here, neither the United States nor the EC recognize any such defense to exclusive dealing, but other countries including Denmark, France, New Zealand, Russia, and Turkey do (ICN paper p20). Perhaps we should investigate further the reasons for the differences on

such an important issue.

VIII. THE EXCLUSIVE DEALING PARADOX

Historically in Europe, we have always seen exclusive dealing as the end of a spectrum starting with pure competition on each individual order, moving through volume, target, and fidelity rebates and ending with complete exclusivity. One notable feature of the EC and DOJ papers is how we begin to see that this is not the case. Both agencies find it easier to state their position on exclusive dealing. The practice is simpler, both in its execution and in its regulation. One Section 2 hearing panelist even suggests that single-product loyalty rebates occur only with firms which have substantial market power, unlike exclusive dealing which is more prevalent (footnote 134). (That is questioned by Muris and feels not quite correct but one can see the thrust of the point.)

IX. FINAL REMARKS

The exclusive dealing paradox brings us neatly back to where we started. Why are rebates so hard? Why are they different to other abuses? Why are they—as opposed to any other form of abuse—the “Frankenstein's monster” created by the Commission which has wreaked such havoc (through restrictive Court judgments) long after the Commission has moved on? There are several reasons. One is that, as the Commission observes in footnote 26 of its Guidance, unlike predation—and, we might add, unlike margin squeeze—they do not always entail sacrifice. This makes it difficult for the Commission to characterize them as “recourse to methods different from those which condition normal

competition,” the legal test for abuse (*Case 85/76 Hoffman-La Roche v Commission [1979]ECR 461, para 91*). Another is that, again unlike the other pricing abuses, rebates focus on a *subset of sales*. This immediately makes the analysis more complex. It gives rise to constructs, such as loading the discount on the portion of sales judged by regulators or courts to be “contestable.” That is a completely different proposition from regulating predatory pricing or margin squeeze. To believe in it requires a huge “leap of faith” in our competition regulatory system, and in the capacity of the judges and regulators to whom the decision will fall to get it right. This is why the DOJ is right to conclude that “further assessment of the real-world impact of these discounts is necessary before concluding that standard predatory-pricing analysis is appropriate in all cases” (p116, Single Firm Conduct report). And this is why the Commission has introduced all the safety valves into its own analysis framework.

And so, three years on, we return to the Southern Ocean. It is still raining hard, and we have none of the comforts of a car. But our boat is perhaps a little bit stronger, our vision a little bit sharper, and with good fortune we should keep it upright as we learn from experience in the years ahead.