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How should companies shape their rebate systems?

From the editor

Rebate systems are one of the most controversial topics in competition law. They are distinguished from ordinary price reductions as they are provided to a group of customers with conditions tied to the rebates applicable. On the one hand, rebate systems benefit consumers through lower prices; on the other hand, they have the potential to cause anti-competitive harm when they are exercised by dominant firms. Thus, it is difficult to assess whether rebates are pro-competitive or anti-competitive.

Belit Polat, an experienced competition lawyer, assesses in this paper how competition authorities in the European Union, the US and Turkey approach rebate systems. After analyzing several cases, she points out the gap between the effects-based standard and form-based policy followed by the Turkish Competition Authority. Belit also provides practical guidelines for firms to assess their rebate systems.

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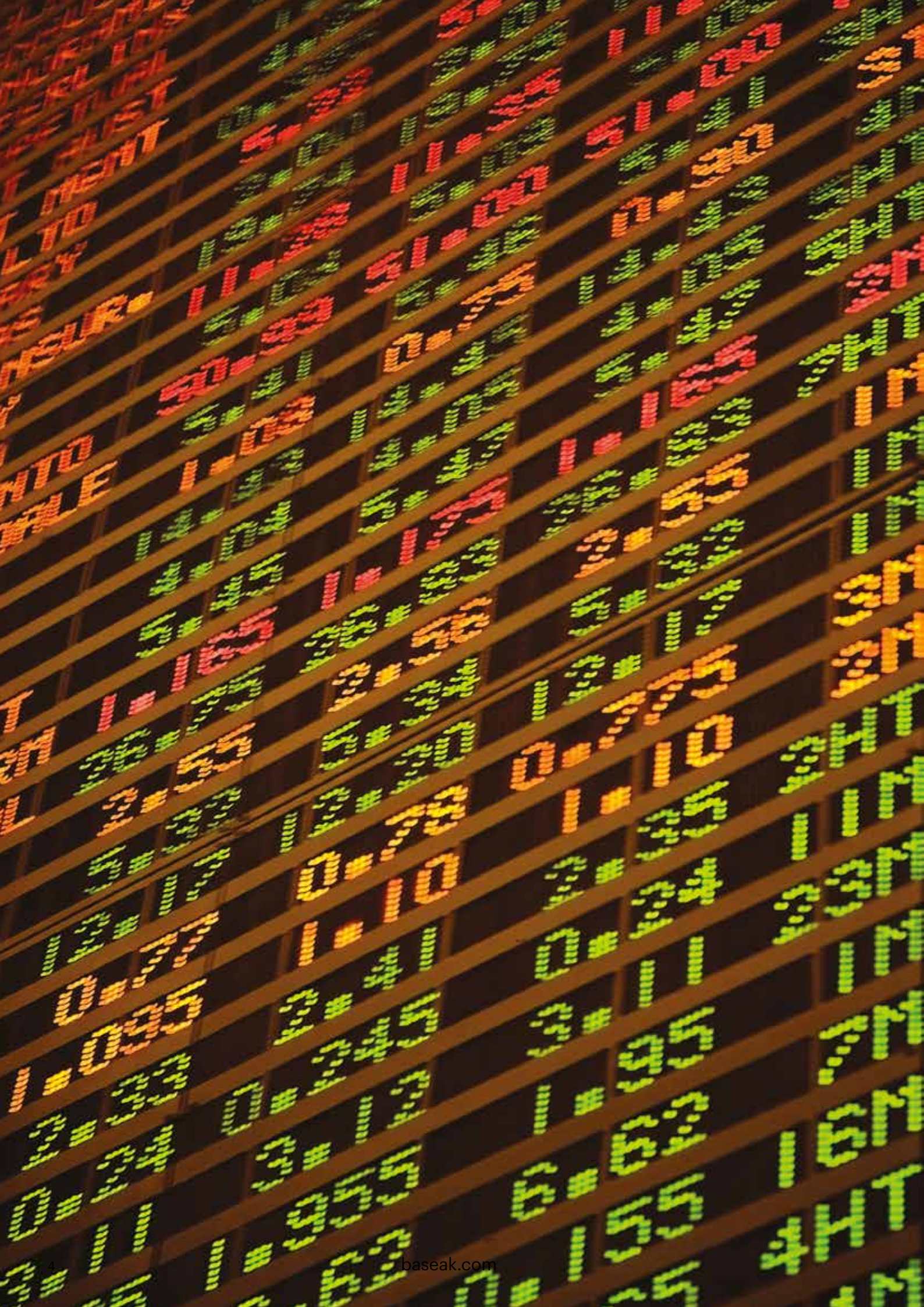
Definition and classification of the rebate systems

In general, price discounts provided in return of certain customer behaviors are called "rebate systems."[1] In regard to competition law, rebate systems arise as a result of either unilateral behavior of the supplier or through a meeting of the minds between customer and supplier. Rebate systems are distinguished from ordinary price reductions as they are provided to a group of customers due to conditions tied to the rebates applicable. In general, within the aforementioned condition, the customer is expected to commit an obligation proposed by the supplier, or it is aimed for the customer to adopt a certain behavior.[2]

Rebate systems are generally classified in the doctrine according to different criteria:[3]

- **Within the scope of the classification based on the number of markets affected by rebate;** condition on purchasing from a single market by the buyer is called "single-product rebate." If rebate system conditions the purchasing from more than one product market, such rebate is called "multi-product rebate."
- **Within the scope of the classification as to the extent of the rebate;** rebate granted on all purchases after achieving the threshold is called "retroactive rebate." If there is a rebate on the excess purchases over the threshold, such rebate is called "top slice rebate."
- **Within the scope of classification as to the ratio of the rebate;** if the rebate ratio changes between the quantities of purchase, it is called "progressive rebate," if the rebate ratio is fixed for all quantities that is "fixed ratio rebate."
- **Within the scope of classification as to the effect of rebate on each individual buyer;** quantity discounts and loyalty rebates may be named. These types of rebates are also called "exclusivity rebates."



Rebates and competition policy

While discounts or rebates have been used by businesses for centuries to sell greater amounts of products to customers, it is true that the compatibility of rebates with competition law has become a particularly acute issue in recent years. Indeed, while many can't specifically define rebate systems, some of the Competition Authorities consider loyalty discounts and rebates a legitimate form of price competition, and they think loyalty discounts and rebates can benefit consumers through lower prices. But also, when it is exercised by the dominant undertaking with considerable market power, such rebates have potential to cause anti-competitive harm.

Leading competition lawyers and economists discuss the objective of competition policy in relation to the rebate systems of the undertakings. For instance, Motta explains that it is difficult to say whether price discrimination and rebate systems have a positive or negative impact over consumer welfare.[4] Geradin distinguishes rebates as pro-competitive conditional rebates from anti-competitive ones.[5] Also the OECD in its report overview emphasizes that it is hard to distinguish pro-competitive rebates from anti-competitive rebates.

Assessments of the approach of EU and US authorities on rebate systems

Most of the competition authorities consider case-by-case evaluation while assessing the anticompetitive effects of rebates. Predatory pricing and exclusionary effect is considered to be the limit for the dominant undertakings. The assessment is positive until there is an anticompetitive effect in place. These last few years have witnessed several major court judgments in the EU and the US, which have been abundantly commented upon, hence an explanation for the large number of papers and seminars devoted to the subject.[7]

The EU courts adopted a number of important judgments addressing the compatibility of loyalty and other forms of rebates with Article 102 TFEU. Many commentators deplore that the EU Commission has not yet come up with a conceptual framework which would enable dominant undertakings to assess the risk of their rebate systems properly.[8]

The obvious starting point is the Court of Justice's judgment in Hoffman-La Roche v Commission.[9] Hoffman–La Roche concerned fidelity agreements whereby Roche paid a rebate to its customers who obtained all or most of their requirements from it. The CJEU ruled that when a dominant undertaking applies "a system of fidelity rebates, that is to say discounts conditional on the customer's obtaining all or most of its requirements-whether the quantity of its purchases be large or small, it violates Article 102 TFEU."

In Michelin I, the CJEU observed that the rebate regime in question did not fit within the distinction made in Hoffman–La Roche between fidelity and volume rebates. The case made clear that a lack of transparency in a rebate system is an exacerbating

factor, making a finding of an abuse more likely.[10] A few years later, the Commission had inferred that the rebates were loyalty-inducing in light of the fact that the discount was calculated on the dealer's entire turnover with Michelin (so-called "retroactive rebates.")[11] The General Court considered that for the purposes of establishing a breach of Article 102 TFEU, it is sufficient to show that the abusive conduct of the dominant undertaking "tends to" restrict competition or, in other words, that the conduct "is capable of" having that effect. The strict treatment of loyalty rebates can be found in several further cases.[12]

The EU courts' case-law on rebates, but also on other forms of unilateral conduct by dominant undertakings, was severely criticized by scholars and practitioners as excessively formalistic and not in line with the teachings of economics. Following the adoption of the Guidance Paper,[13] discussions evolved from the formalistic approach pursued by the EU courts. The Commission intended to investigate "to the extent that the data are available and reliable" whether the rebate granted by the dominant undertaking is capable of hindering the expansion or entry of "as efficient" competitors by making it more difficult for them to supply part of the requirements of individual customers. With the publication of the Guidance Paper, it was considered that the Commission made a significant step in the transition to a more economically sound treatment of exclusionary abuse, in particular in relation to loyalty discounts.[14]

While the judgment of the CJEU in Tomra[15] came after the adoption of the Guidance Paper but three years before its 2009 Guidelines[16] on abusive exclusionary conducts, the Commission held that Tomra abused its dominant position by implementing individualized loyalty rebates, exclusivity agreements, and individualised quantity commitments. On appeal to the General Court, Tomra argued that the per se approach endorsed by the Commission with no analysis of actual effects of the discounts has no basis in business practice. However, the court held, there is no requirement under the law to analyze whether the rebates actually had this effect on the market or to establish that there had been below-cost pricing. The ECJ confirmed the General Court's ruling.

Following from the traditional approach, another problem was that the law on rebates has developed with little or no reference to the evaluation of a rebate system. The recent legislation, the Guidelines says that, in determining whether a dominant undertaking's pricing should be condemned, it is appropriate to look at the relationship between the undertaking's costs and its sales prices.[17] However, the case law on rebates, which developed from the rule against dominant undertakings entering into exclusive purchasing agreements, does not have an explicit cots component, other than that a rebate can be defended on efficiency grounds. Against this background, the Commission's recent commitment to assess rebates under a more effects-based approach is arguably one of the more significant improvements of EU competition policy in the past decade.

Post Danmark[18] may be considered as setting the direction which EU law on exclusionary abuses, and it could be read as an attempt to dispel uncertainties around the Commission's new effects-based approach and its compatibility with Article 102 TFEU. In Post Danmark, the Court stated that the purpose of Article 102 TFEU is neither to prohibit undertakings from achieving, on their own merits, economic power equivalent to dominance, nor does this provision seek to ensure that competitors less efficient than the undertaking with the dominant position should remain on the market. The ECJ also stated that Post Danmark's rebates were different from loyalty rebates.

Several commentators agree that Post Danmark could be read as advocating the use of as efficient competitor principle beyond practices that were the subject of that judgment. If dominant undertakings have the right to compete and possibly exclude their less efficient competitors, and since Article 102 TFEU does not aim to protect less efficient competitors, then, in order to make these rules applicable, it is argued that the as

efficient competitor test[19] should also be used in determining whether rebate schemes of dominant undertakings are abusive or not.[20]

However, in Intel case,[21] when the Guidelines were to be applicable, the Commission seems to be returning to the older case law and has not relied on the Guidelines as would be expected. The Commission imposed on Intel a €1.06 billion fine, the highest penalty ever imposed in Europe in a single firm conduct cases. In the Intel case the Commission stated that "the Guidance paper is not intended to constitute a statement of the law and is without prejudice to the interpretation of Article 82 [TFEU Article 102] by the Court of Justice or the Court of First Instance."[22]

The decision sets out how Intel infringed competition law by engaging in two types of practices. First, Intel gave wholly or partially hidden rebates to computer manufacturers on the condition that they bought all, or almost all, their CPUs from Intel. Second, Intel made direct payments to computer manufacturers to stop or delay the launch of specific products

containing a competitor's CPUs and to limit the sales channels available to these products. The Commission followed its 2009 Guidelines and applied the effects-based approach to find that the rebates in that case were abusive.[23] However, the Commission also performed a separate analysis of Intel's rebates under the traditional per se approach and found the rebates to be abusive. Intel appealed the Commission's decision before the General Court. However, the Court stated that such rebates are designed to remove or restrict the purchaser's freedom to choose his sources of supply and to deny other producers access to the market.[24]

In conclusion, rebates and discount schemes applied by dominant undertakings have been found abusive when given in exchange for customer loyalty or when they are found to be loyalty-inducing.[25] Despite the effects-based approach promoted by the Guidelines and the abundant legal and economic literature suggesting that loyalty rebates should not be subject to a per se rule of illegality, recent case-law showed that the Commission and the Courts failed to apply the Guidelines and felt somewhat compelled to adhere to the per se rule of illegality contained.[26]

While the US courts and enforcement authorities have not settled on a consistent approach to loyalty discounts, most US variations differ markedly from the approach taken by the EU courts. The US Department of Justice in 2008 issued a competition and monopoly report on single-firm conduct under Section 2 of the Sherman Act.[27] Exclusionary conduct, bundled discounts and single-product discounts are potentially recognized in the Report as monopolization or an attempt to monopolize any part of free-trade. At that point, the US authorities use a narrower definition, referring only to offering discounts or rebates on all units of the customer's purchases.[28]

Under the Supreme Court's decision in Brooke Group,[29] the plaintiff seeking to prevail on a predatory pricing claim must prove that the defendant's prices were below an appropriate measure of the defendant's costs; and there was a dangerous probability that the defendant would recoup its investment in below cost pricing.[30] However, the LePage's Inc v 3M case[31] would be a remarkable example to show the approach of the US authorities on rebate systems. Indeed, the defendant, 3M, had a market share of more than 90% in transparent tape which was a

product for which it faced significant competition from LePage who argued that 3M's bundled rebate system constituted monopolization under Section 2 of the Sherman Act. The allegation was that 3M bundled rebates relating to the purchase of its private-label tape with a requirement that customers purchase other products from 3M's different product lines that LePage's did not offer.[32] The Third Circuit found that 3M's practices had long-term anti-competitive effects and held that violation could occur if a monopolist engaged in exclusionary conduct without a valid business justification.

It can be concluded that US practice is backing the rebate strategy considering that rebates as discounts are pro-competitive per se. Only under certain circumstances, such as if the undertaking has a dominant position and monopoly power, might rebates become anti-competitive.[33]

Assessment of the Turkish Competition Authority

Rebate systems under Turkish competition law practice may be analyzed under Article 4 which prohibits agreements distorting competition or under Article 6 which prohibits the abuse of the dominant position, of the Law on Protection of Competition numbered 4054 **(the Competition Act).**

Although there is no explicit phrase regarding the rebate systems in the text of Article 4, in practice it is seen that the rebate system generally appears in cases where there is a vertical agreement between the supplier and the buyer. Among the decisions of the Turkish Competition Authority **(the TCA)**, decisions where rebate systems are analyzed in accordance with Article 4 of the Competition Law are the ones which are mostly related to the issues of providing the exemptions provided in accordance with the Block Exemptions Regulations regarding the Vertical Agreements No. 2002/2 and of not granting one. Moreover, although there is no explicit clause regarding the rebate systems in Article 6 of the Competition Act, the TCA analyzes rebate systems as one of the examples of the breach types counted in the second clause of Article 6.

Moreover, the TCA issued Guidelines[34] setting out the TCA's position on Article 6 of the Competition Act which concerns the abuse of a dominant position. The Guidelines are specifically related to exclusionary abuses by dominant undertakings but not exploitative abuses and discriminatory abuses by such undertakings. Also, as for the rebate systems, the TCA addresses that, whether a rebate system implemented by a dominant undertaking is likely to cause anti-competitive foreclosure, the Board will consider several factors such as the equally-efficient competitor test.

It appears from recent investigations that after efforts to revoke the benefits of block exemption regulations from dominant undertakings especially operating in various FMCG sectors, the focus of the TCA on rebate systems intensifies. Practices such as loyalty rebates and market share discounts are commonly investigated in practice, especially in the FMCG industry. The formalistic treatment of loyalty rebates can be found in several further cases.

In Turkcell, the TCA concluded that Turkcell abused its dominance by, among other things, applying rebate schemes to encourage the use of the Turkcell logo and refusing to offer rebates to buyers who also deal with Turkcell's competitors.[35] Similarly, in Doğan Holding, the TCA condemned Doğan Yayın Holding for abusing its dominant position in the market for advertisement spaces in daily newspapers by applying loyalty-inducing rebate schemes.[36] That said, Microsoft was investigated, and the TCA decided that there is no abuse as the rebate systems of Microsoft do not lead to discriminatory or exclusionary behaviour.[37] In Amadeus, the TCA concluded that the loyalty rebates and incentive

payments granted by Amadeus for exclusivity covers a small portion of the market, but the TCA preferred to deliver an opinion to Amadeus to terminate its exclusivity practices.[38] Also, in Ülker, the TCA admitted that discounts based on efficiency gains are acceptable from a competition law perspective; however, loyalty discounts as incentives to increase loyalty of the buyer may be considered abuse.[39]

In one of TCA's several decisions in relation to Coca-Cola,[40] TCA ordered that the agreements which Coca-Cola and/or its dealers concluded with the sales points and exclusivity clauses of those agreements and practices, which causes exclusivity ipso facto, such as free product, discount, quota, refrigerator exclusivity, have effects that cannot be granted any exemption. In another decision regarding Frito Lay, the TCA considered whether or not granting rebates for exclusivity breached the competition law. While evaluating the rebates granted for exclusivity factors, the TCA concluded that Frito Lay aimed at ensuring exclusive sales of its products at the sales points. TCA did not perform an analysis pursuant to the rules governing abuse of dominant position but concluded that these practices were in violation of the decision that revoked the exemption, and the approach was again form-based.[41]

One of the most recent TCA investigations was initiated into Mey İçki, concerning alleged practices that obstacles competitors' activities in the rakı market and thus violated Article 6 of the Competition Act. As a result of the investigation, the TCA concluded that Mey İçki infringed the Act and imposed an administrative fine due to the rebate and exclusivity practices leading to excluding competitors and foreclosure. The decision included mostly emails as proofs that generally show aggressive strategies of sales personnel at the local level to get share in sales point with possible implications of foreclosure, and all the defences regarding the limited effect of the practices and competition on merits were found irrelevant by the TCA. Despite the arguments raised on effects-based approach, which requires using economic methods to show the impact in the market, the TCA mostly focused on circumstantial evidence of internal emails between the sales personnel and regional and higher level managers.[42]

In conclusion, the TCA prefers not to follow methodology despite the fact that the Authority's own Guidelines recommend showing the actual effect by applying an efficient competitor test in case of discounts and related practices. Consequently, the gap between the effects-based standard and form-based policy is wide.

Basic tests to evaluate Anti-Competitive Rebate Systems

With respect to the case-law referenced above, the anti-competitive foreclosure effect can be analyzed under different models. The main three models are the "No Economic Sense Test, the "Equally Efficient Competitor Test" and the "Consumer Welfare Test."

No economic sense test:

The "no economic sense test" stems from the "sacrifice-based test" where "conduct was tagged as unreasonably exclusionary if (but not because) it involved a sacrifice of immediate profits as part of a strategy whose profitability depended on the exclusion of rivals." It is considered to be a refined version of the "sacrifice-based test."

It is widely known that in the "no economic sense test" first of all a short-run profit sacrifice must be determined. Upon determination of such sacrifice, the rationality behind the sacrifice is questioned.[43] If it is concluded that there is some economic sense (meaning; a profit enhancing rationale) besides a lessening of competition, then the behavior is regarded to not amount to a "predatory" or "exclusionary" conduct.

The main principle is that "conduct is not exclusionary or predatory unless it would make no economic sense for the defendant but for its tendency to eliminate or lessen competition."[44] Accordingly, the burden of proof rests with the plaintiff as it has to demonstrate that the challenged conduct would not be rational absent the tendency to eliminate competition.[45] For example, in Trinko,[46] the DOJ contended that "conduct is not exclusionary or predatory unless it would make no economic sense for the defendant but for its tendency to eliminate or lessen competition."[47] In Microsoft,[48] the DOJ argued that a course of conduct that served to protect the defendant's operating system monopoly was exclusionary because it "would not make economic sense unless it eliminated or softened competition."

Equally efficient competitor test

The "equally efficient competitor test" also known as the "as efficient competitor test" assesses whether the conduct challenged is capable of excluding an equally efficient competitor to the dominant undertaking without incurring losses.

The test was first developed by Chicago School law scholar Richard Posner who assessed the application of the concept to predatory pricing practices and different approaches stemmed from Harvard School scholars Phillip Areeda and Donald Turner. The test is widely adopted in the EU case-law and is applied in a series of margin squeeze and selective pricing cases. The Commission's Guidelines also recognizes the equally efficient competitor principle, but the case-law practice is arguable.

Basic Tests

To evaluate Rebate Systems

No Economic Sense Test

Whether the conduct is unreasonably exclusionary and involved a sacrifice as part of a strategy depended on the exclusion of rivals.

Equally Efficient Competitor Test

Whether the conduct is capable of excluding an equally efficient competitor.

Consumer Welfare Test

Whether the conduct reduces competition without creating a sufficient perfomance.

Overall, the test focuses on cost-analysis, and choosing an appropriate cost benchmark is regarded to be crucial. Accordingly, the EU Commission uses the average avoidable costs (AAC) or the long-run incremental cost (LRAIC) as benchmarks in a cost- analysis.[49] As a final note, the equally efficient competitor test was raised on a

shield by the ECJ in Post Danmark. In addition, even if a formalist approach was performed in the Intel loyalty rebates case, the test was also applied alongside.[50] Even though the TCA's Guidelines[51] on exclusionary abuses stipulates that the Authority may consider several factors such as the equally-efficient competitor test while assessing the abuse, the TCA generally prefers not to follow this methodology in assessing rebate systems, as noted before.

Consumer welfare test:

The "consumer welfare test" assesses whether the conduct reduces competition without creating a sufficient improvement in performance to fully offset the potential adverse effects on prices preventing consumer harm. In the analysis, efficiencies which may be passed on to consumers in the form of lower prices are considered.[52] In Microsoft, the incentives balance test (a sub-kind of the consumer welfare test) has been employed by the Commission in order to dismiss Microsoft's claim that the disclosure of interoperability information would have reduced its incentives to innovate.[53] Currently, the test, which has developed in the US, is argued to be "not administrable" as it imposes undue burden and uncertainty on defendants.[54]

Final remarks and guidelines for undertakings

In practice, it may often be difficult to draw the line between legitimate conduct and the prohibited abuse of a dominant market position in the area of rebates and bonuses. Much could be gained if the two lines of case law (per-se analysis and effects-based approach) converged into the cases which may be known to be more appropriate. This is because the decisions do not enable to deduce on de facto evaluation of rebate systems, and there is an absence of consistency and clarity in the decisions on the rebate systems.

It seems that different factors have been taken into account in different cases while assessing if the rebate systems are "loyalty-inducing" or not. When the case law in US and EU on rebate systems are compared, it is recognized that the analysis of rebate systems in US mostly takes into account economic factors. The determination of whether a rebate system causes exclusion is only possible by revealing the effects in the market level.

With respect to the competition law analysis concerning rebate systems, adopting a formalistic approach without considering its effects on the market may cause the prohibition of much competitive behaviour through competition rules.[55] However, competition authorities generally refrain from applying their own legislation, therefore the guidelines remain as guidance, not law.

Everything considered, it would be advisable for the undertakings to pay attention and consider the following when developing rebate systems:

Head-to-head competition is more robust when competitors can contest all units:

Estimating a "contestable share of demand" in the market is regarded to be difficult, but it does not come forth as a main issue. Especially in situations where smaller competitors compete for various units of different customers, the estimation is regarded

to be rather easy. Thus, the type of rebate adopted by the dominant undertaking does not matter much in assessment of compliance with the as-efficient-competitor test.

Place attention to the rebate structure of must-have products:

If a dominant producer has a "must have" product in its portfolio, more thought has to be given to the arrangement of the rebate structure. The adoption of incremental rebates rather than retroactive rebates will likely help companies avoid a violation of the as-efficient competitor.

Multiple thresholds for must-have products with retroactive rebates may be acceptable:

Retroactive rebates or other more complex incentive schemes may be crucial for customer satisfaction reasons. Retroactive rebates or other more complex incentive schemes may still be adopted, provided that they meet certain standards. However, if the dominant producer with a "must-have" product in its portfolio decides to adopt such systems, the structure must be designed in a manner that ensures that the tendency to cause foreclosure in the market is minimized.

Each customer is valuable:

Individualized rebates are generally considered to be compliant under the assessment of the as-efficient-competitor test. Accordingly, as individualized prices are regarded to be important tools allowing effective competition for contestable units, the altered perspective on individualized rebates reflect on the effects based assessment of the rebates.

The reference period is also important:

The length of the reference period for a rebate is relatively unimportant as a cause for foreclosure, compared to the rebate percentage and the threshold where the rebate is applied. In the circumstances, the length of the reference period indicates the foreclosure effect attributable to the supposed abuse.[56]

Avoid punishments and threats:

Customers may want to shift their orders, change to competing suppliers. However, no threat or punishment should be imposed on the customers due to their choice to work with the competitors. The punishments that customers are subject to are inquired when conducting the as-efficient-competitor test since from an economic perspective, the actual price changes that a customer would face when it reduces demand reflect on properly derived counterfactual prices, and this includes possible withdrawals of bonuses and discounts as a punishment.[57]

Pay attention to internal correspondences:

As seen in TCA's decisions especially concerning rebate systems, prior to evaluation of the effects of the allegedly foreclosing behavior, evidence seized during dawn-raids are analysed. Aggressive correspondences against competitors and correspondences which are open to misinterpretation may be used as material indicating "anti-competitive intent," and this may lead to prejudiced evaluation of the rebate systems which may not carry any anti-competitive risks and may elongate the duration of the investigation. Therefore, companies must pay attention to internal correspondences and must avoid using words that could be open to misinterpretation when explaining commercial matters.

Discuss the concessions in both a legal and an economic perspective:

Balancing practices which carry commercial benefits but also carry risks is important and must be taken into account when deciding on matters concerning operation of daily business such as targets, budgets and premiums. Thus a system which complies with both law and practice and addresses commercial needs must be determined, and both the legal and economic dimensions of the said system must be evaluated.

Additionally, explicit or implicit competitor policies gain significance when assessing if the rebate systems cause an infringement. Thus, companies must be aware of how to react in a dawn raid and should seek guidance from consultants on legal and economic matters before developing rebate systems.

Guidelines for undertakings

It would be advisable for the undertakings to pay attention and consider the following when developing rebate systems:

1. Head to Head competition is much robust when competitors can contest all units

2. Place attention to the rebate structure of must-have products

3. Pay attention to the design of the rebate systems for must-have products

4. Individualised rebates pay role on the effects

5. Longer reference period indicates foreclosure effect

6. Avoid punishments and threats to customers in case of order shifting

7. Pay attention to internal correspondences

8. Discuss the concessions in both legally and economic perspective

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Presently, Şahin leads the Competition law and Regulatory practice of the office. His theoretical and practical proficiencies allow him to counsel clients on a broad range of competition and antitrust issues, with the objective of providing real-world solutions on countless transactions, agreements and competitive concerns.

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Balcıoğlu Selçuk Akman Keki Attorney Partnership is an Istanbul-based full service law firm with a team of 75-plus lawyers and economists. Our practice focuses on a wide range of areas including real estate, corporate, mergers and acquisitions, banking, project finance, capital markets, competition and anti-trust, employment, litigation and arbitration, telecommunication, regulatory and public law and intellectual property. We represent and advise Turkish and multinational clients, including Fortune 500 companies, in the banking and finance, private equity, real estate, manufacturing, hospitality and leisure, retail, automotive, energy, information technology, life sciences, luxury fashion and beauty, and media sectors.

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