EU *Intel* Judgment and more on Rebates

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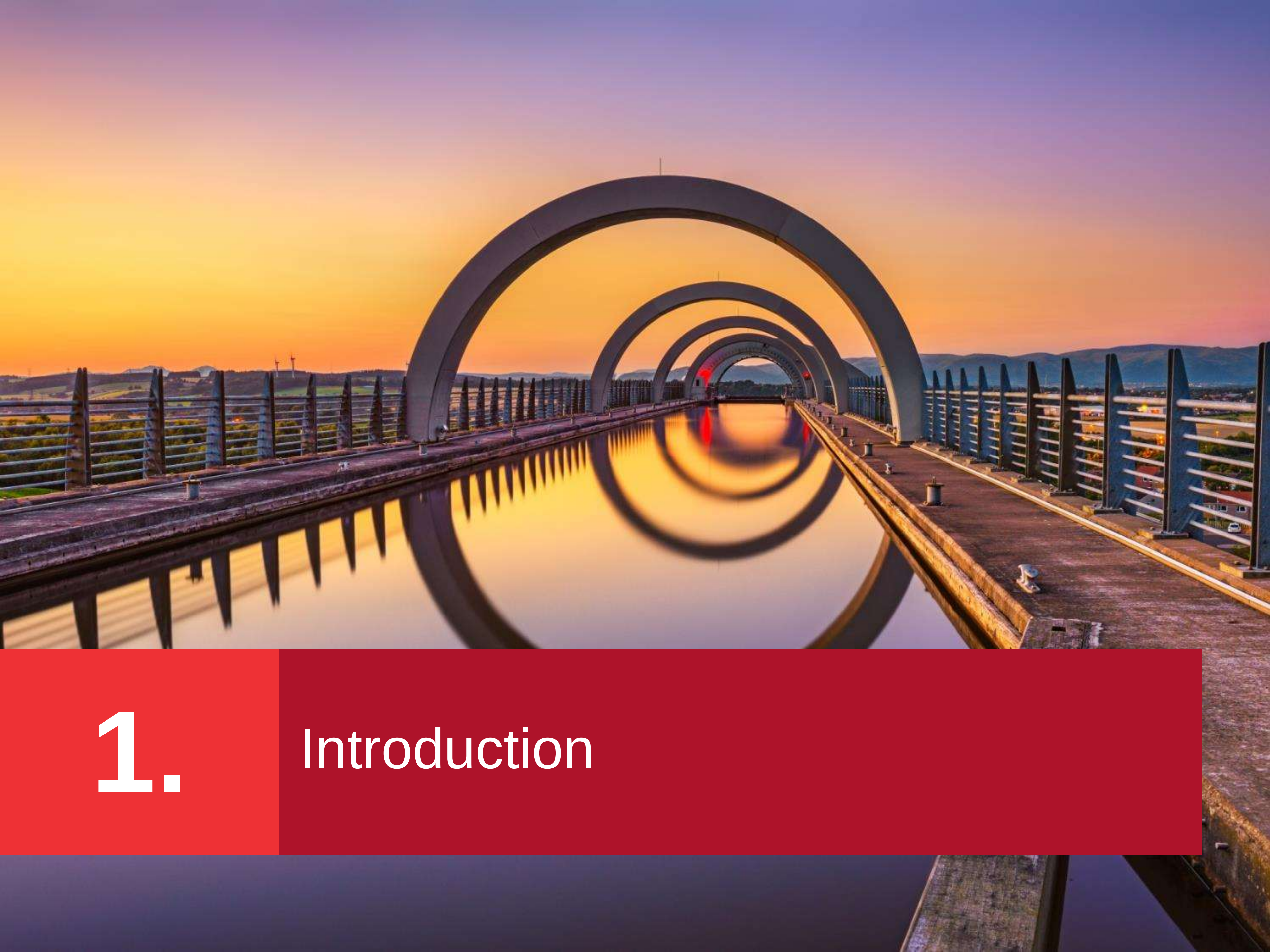
Agenda



1. Introduction

Introduction

- *Intel* judgment is a major departure from prior case law:
  - Clarifies when a dominant company's rebate schemes may be abusive
  - By favouring an economics approach, *Intel* gives companies greater scope for crafting compliant rebate schemes
- Understanding the EU competition law rules on rebates and how to apply these in practice remains crucial for companies at risk of being found dominant → real risk of high fines
- Today's objective:
  - Explain how *Intel* has changed the assessment of rebates and discounts
  - Provide guidance on
    - How to design and implement competition law compliant rebates and discounts
    - When to seek the assistance of economists

Rebates – a quick recap

- No dominance = no problem under Article 102 TFEU
- Dominance:
  - Risk where market shares >40%
  - Presumed where market shares >50%
  - Also consider: market share trends over time, competitors' market shares, barriers to entry etc.
- Dominance itself not problematic but *abuse* of dominance is
- Possible defences: objective justification and efficiencies

Rebates – a quick recap (cont.)

- Assessing whether rebates are problematic under EU competition law or not basically involves a three step analysis:
- Step 1: Calculate the effective price
  - The Effective price is the price that an as efficient competitor needs to offer to convince customers to switch at least part of their purchases from the dominant company to that competitor
- Step 2: Identify relevant costs
- Step 3: Check whether the effective price is below the relevant costs

2. The *Intel* judgment

The *Intel* saga

- 2009: European Commission fines Intel EUR 1.06 billion for abuse of dominance
- Relevant market:
- x86 CPUs for desktop pcs, laptops and servers
  - Intel: 80% market share worldwide
  - high barriers to entry/expansion
  - One rival (AMD) was becoming a greater threat to Intel
- Problematic conduct:
  - Intel offered rebates of up to 16% to 4 major PC manufacturers, conditional on 80%(+) exclusivity
  - Intel paid PC manufacturer to delay introduction of ADM products
  - Intel paid major retailer not to stock AMD pcs
- 2014: General Court upholds European Commission decision
- 2017: Court of Justice sets aside General Court judgment

… the saga is not over yet (for Intel)!

Intel judgment: no (quasi) *per se* illegality?

Pre-Intel

(Quasi) Exclusivity	"Third category"	Pure quantity volume based

Post-Intel

"Third category"	Pure quantity volume based

Does that mean that (Quasi) Exclusivity schemes are now OK?... **NO**

Intel judgment – full merits analysis …

- … must involve consideration of:
  - the extent of the undertaking's dominant position on the relevant market
  - the share of the market covered by the rebate
  - the conditions and arrangements for granting the rebate(s) in question, their duration and amount
  - the possible existence of a strategy aimed at excluding as efficient competitors (AEC) from the market

The *Intel* Judgment – what’s changed?

- No *per se* illegality for (quasi) exclusivity rebates
- (Re)injection of economic analysis: AEC at the centre of a full analysis? Strength of other (quantitative or qualitative) evidence?
  - BUT see *Qualcomm* …
- Required strength of the “no foreclosure defence” to trigger a full analysis? “Quick glance” analysis by authorities possible?

Intel and the Priorities Guidance

- Intel requires an analysis of whether the rebate may exclude an as efficient competitor (AEC) → competition law should not protect inefficient companies
- Priorities Guidance sets out how this analysis may be conducted:
  - Step 1: Assess the contestable share. “How much of a customer’s purchase requirements can realistically be switched from DomCo to another supplier?” (Only for retroactive rebates)
  - Step 2: Calculate the effective price spread over the contestable share which must be offered by a competitor to match the value of DomCo’s rebate.
  - Step 3: Identify the relevant costs.
  - Identify whether the effective price is below cost. If so, there is a risk of illegal foreclosure.

Intel – who are the winners and losers?

WINNERS

- DomCos in general/more flexibility — solid accounting becomes a bonus given the importance of AEC test
- Commission, CET in particular, at policy level
- Effects-lead v by object violations (general trend?)
- Those who called for a heavier scrutiny of the Commission's decisions by the Courts

LOSERS

- The Commission/NCAs when they desire to intervene (more work to be done and higher chance that their decisions will be overturned on appeal)
  - But note that Commission officials have stated publicly they do not expect *Intel* to change their assessment in practice
- Complainants/Competitors of DomCos (both before authorities and national courts)
- General Court (much tougher job — they need economic expertise)
- National Courts (as per General Court)
- Claimant firms (in general and esp. re standalone actions)

3. Designing/defending rebate schemes *post-Intel*

Three lines of defence (Pre and Post Intel)

Authority/Claimant

NO DOMINANCE

NO ABUSE | INTEL | NO ABUSE

INTEL - *DE MINIMIS* (All circumstances)

OBJECTIVE JUSTIFICATION/EFFICIENCIES

Proposed (pragmatic) approach

AEC test every time? NO

- Not the only tool (and not without its issues: *contestable share, reference period, allocation of common costs, multi-product rebates etc.*)
- Not always practical (let alone cost effective)

Creation of protocol/screens for "potential for exclusion" instead:

- Examine capacity to foreclose and use safe harbours/red flags (below)
  - if concerned, can the commercial objectives be achieved in a less "aggressive" manner
  - if not: quick look or full-blown AEC test
- Ensure business awareness and escalation of problem (monitor)

Factors to examine before a full-blown AEC | 1

1 Structure of the market/alleged dominance?

- Super-dominance/statutory monopoly?
- Barriers to switching and barriers to entry and expansion?

2 Is it a “winner takes all” market?

- Can small competitors bid for an entire customer’s needs?
- If so, **only** need check whether there is a positive margin on the overall price

3 What % of the market affected?

- <5-15% (of what?) perhaps unlikely to be a concern (factual assessment)

BUT remember “one offs” can accumulate; coverage of strategic customers

4 Duration of the scheme?

E.g. seasonal offer? impact on the customers? (very industry specific)

Factors to examine before a full-blown AEC | 2

5 How "aggressive" is the Scheme?

- Exclusivity: e.g. 10% rebate if you buy only from us/80% of your requirement from us
- Stretch: e.g. 10% rebate if you buy 20% more than prior year
- Tailored: e.g. 10% rebate if you buy at least 10m (We know 10m is a high percentage or all of customer's needs)
- Rollback aka Retroactive: e.g. 10% rebate paid if you buy 100 on all 100 units
- Incremental: e.g. 10% rebate paid on units bought above 100 (on units 101, 102, 103 etc.)
- Standard: e.g. 10% rebate on all units bought

Aggressive

Gentle

Factors to examine before a full-blown AEC | 3

6 Can our competitors replicate the scheme?

- Can our competitors match our price for the last unit? Can they offer the same "package"? Are we losing money on this?
- Is the customer punished if she switches away (and if so, how much)?

7 Strategy (and pro-competitive explanations)

- Rebate specific efficiencies?
- Internal documents
- Communications to customers (impression given to customers matters most)

8 Reality check: are there counter-indicators of exclusion?

- E.g. aggressive entry and expansion by competitors, no sign of them being unable to bid for contracts

Defusing problem practices

- Convert retroactive rebates to incremental rebates
- Reduce distance between tiers / steps in (aggressive) incremental scheme
- Shift rebate to non-dominant lines
- Remove dominant products from bundle
- General discounts (equally applied to all)
- Pay for specific services (i.e. cost-based compensation)
- Reward documented cost savings (eg grouped deliveries)
- Shorter reference period (i.e. the period over which purchases are considered for the rebate)

4. Working with economists

Economic assessment of rebates

- The European Court of Justice strengthened importance of economic assessment.
- Baker McKenzie Rebate Tool applies the principles laid out in the 2009 EU guidelines
- Rebate schemes offered by a dominant firm can foreclose the market for competitors.
- *Idea:* Test if a smaller as efficient competitor (AEC) can compete with the dominant firm: Can the AEC offer at the same price after-rebate without making losses, i.e. is the price after rebate below cost?
- *If yes:* rebate is in line with the guidance, *if no:* rebate is abusive

Assessing rebates is complex: theory v practice

- Important Question: How can cost of an AEC be measured?
  EU Guidelines propose AAC and LRAIC
- AAC: Average Avoidable Cost
  - Average of the costs that could have been avoided if the firm had not produced an extra amount of output
- LRAIC: Long-Run Average Incremental Cost
  - Average of all variable and fixed costs that a company incurs to produce a particular output
- These are theoretical cost measures which have to be approximated by using financial information of the dominant company.
- Commission Decision (COMP/C-3/37.990-Intel), May 13, 2009
  - Detailed expert's definition of AAC vs. EU Commission's definition of AAC based on publicly available P&L statements

What costs? (Art. 102 Guidelines, para 25)

Rule of thumb: Costs that are directly linked to a specific product or production line

- Average Avoidable Costs (AAC): specific to each unit
  - Raw materials, packaging, direct labor
- Long Run Average Incremental Cost (LRAIC): specific to each production line
  - AAC plus indirect labor, production facilities, logistics, marketing, distribution
  - Difficulty: Allocating marketing, logistics, distribution → Definition of reasonable allocation keys required
  - Excludes costs "common" to other product lines, e.g. back office functions (legal, finance), factory / warehouse covering multiple products
- Average Total Costs (ATC)
  - AAC, LRAIC, plus apportionment of common costs

Costs: Difficult Issues

Deriving costs from client's P&L

LRAIC

AAC

Almost directly attributable

Allocation of costs required

Careful assessment

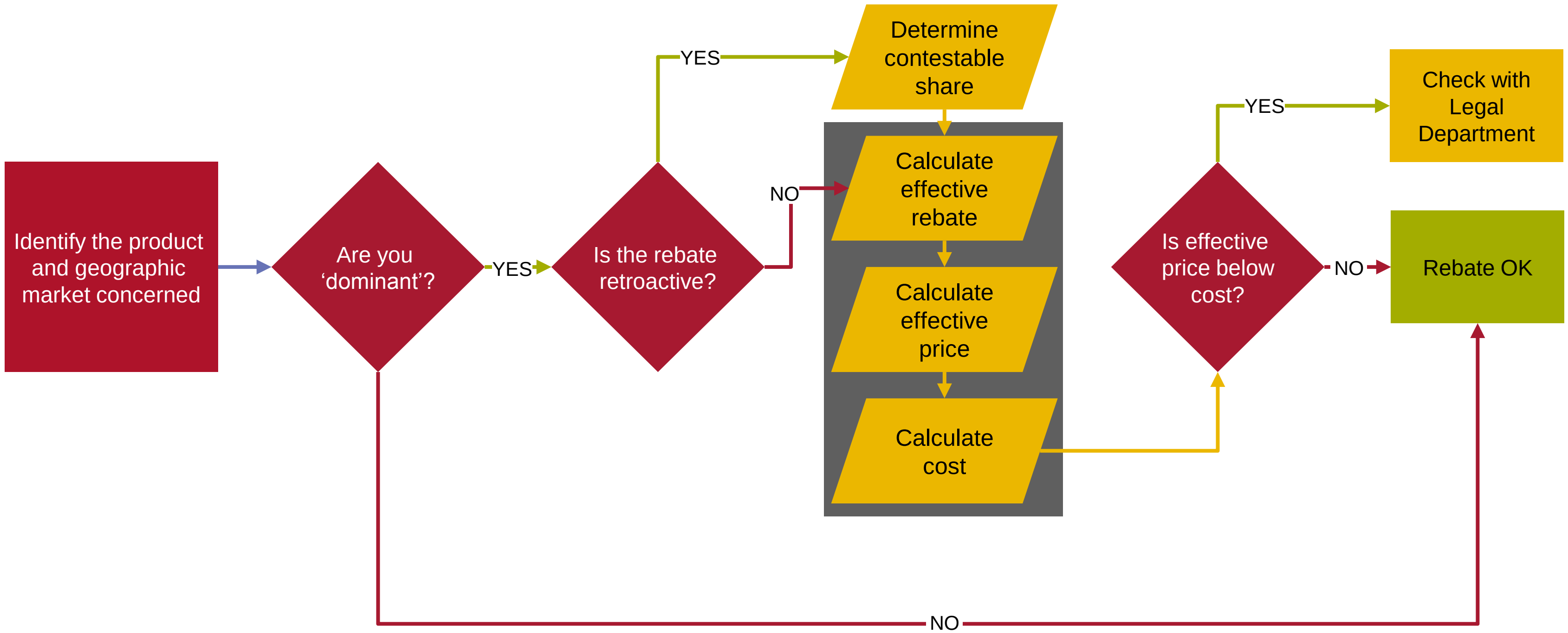
	Total Profit and Loss Statement	Region 1 Product 1	Region 1 Product 2	Region 2 Product 3
Revenues	100	50	30	20
Material Costs	30	15	10	5
Direct Labor	20	10	6	4
Sales, General & Administrative				
- Back Office	10	5	3	2
- Marketing	25	3	1	1
- Distribution	10	5	3	2
- R&D	10	-	-	-
- Legal Services	4	-	-	-
EBIT	11	12	7	6

Theory vs. Practice

- In order to assess a (retroactive) rebate, it is necessary to determine the contestable share of the market, i.e. the market share / share of DomCos sales which a non-dominant competitor can compete for.
- Option 1: Use client's experience / in-house knowledge (e.g. ask Marketing or Sales department).
- Option 2: Determine the contestable market share using actual market shares.
- Option 3: Determine the contestable market share based on consumer preferences.

The Baker McKenzie Rebate Tool

- Translation of the EU guidance into business language
- It helps to optimize rebate schemes.



The Baker McKenzie Rebate Tool

- The Tool makes the economic assessment operationable.
- Follows a simplified P&L Statement

Model with Retroactive Rebate

Approximation of Contestable Share	Units Sold	Market Share / Contestable Share	
Company A (dominant Firm)	500	62.50%	
Planned Sales dominant firm	100	12.50%	Contestable Share
Company B (e.g. largest competitor)	200	25.00%	
Remaining Companies (residual)	100	12.50%	
Total (before Rebate)	800	100.00%	

Market Share / Planned Rebates		
Market Share		62.50%
Contestable (Market) Share		12.50%
Rebate Uncontestable (%)		
Planned Retroactive Rebate		8.00%

Input Cells

See example in present

P&L Statements	Before Retroactive Rebate		Contestable Share (Competitor)	Dominant Firm	Max Rebate
	Total (firm wide)	Segment P &L Product / Market Specific			
Revenues					
Revenues without Rebate	20 000	5 000	1 000	6 000	
Units Sold	2 000	500	100	600	
Revenue per Unit (Effective Price before Rebate)	10	10	10	10	
Directly Attributable Variable Costs (AAC)					
Cost of Goods Sold	8 000	2 000		2 400	
Total	8 000	2 000		2 400	
variable cost per unit		4.00		4.00	
Indirect (fixed) Costs (LRAIC)					
Operating Expenses	600	150		150	
Depreciation	150	38		38	
Further fixed costs	250	63		63	
Total fixed costs	1 000	250		250	
Financial Result					
Financial Income	55	14		14	
Financial Expenses	80	20		20	
Financial Result	-25	-6		-6	
Effective Price After Rebate					
Rebate			480		
Effective Price After Rebate			5.2	9.2	
Variable Costs			400		
Total Costs (Excl. Financial Expenses)			442		
Total Costs (Incl.Financial Expenses)			445		
Cost Measures	Average Unit Costs			Average Unit Costs after Rebate	**Maximum Rebate**
Average avoidable Costs (approx. by Average variable costs)	4.00	4.00		4.00	**10.00%**
Long run average incremantal costs (approx. by average total costs)	4.50	4.50		4.42	**9.31%**
Long run average incremantal costs incl. interest (approx. by average total costs)	4.54	4.54		4.45	**9.25%**

Rebate Evaluation

	Effective Price Increment	Cost Items	EU Guidance
Comparison Effective Price vs. Cost Items	5.20	4.00	O.K.
		4.42	O.K.
		4.45	O.K.
Comparison Effective Price vs. Average Price	5.20	9.20	

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