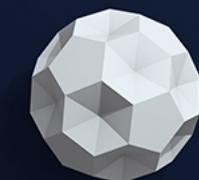


Qualcomm: Exclusivity Rebates Post-Intel

GCLC Lunch Seminar



Raphaël De Coninck, PhD
26 March 2018

CRA Charles River
Associates

ECJ Intel Judgment

Strong endorsement of the principle that article 102 doesn't seek to protect less efficient competitors (e.g. 133, 134, 136 of the judgment)

138/139

In the case where the undertaking concerned submits [...] that its conduct was not capable of restricting competition and, in particular, of producing the alleged foreclosure effects, the Commission is required to analyse:

- The extent of the undertaking's dominant position on the relevant market
- The share of the market covered by the challenged practice
- The conditions and arrangements for granting the rebates in question
- Their duration and their amount
- The possible existence of a strategy aiming to exclude competitors that are at least as efficient as the dominant undertaking from the market (...).

Qualcomm exclusivity rebates



A few questions on Qualcomm's exclusivity rebate case

- Market coverage?
- Static v. dynamic concerns?
- As-efficient competitor test?
- Non-contestable share of the demand?
- Internal documents?
- Duration ?
- Buyer power?

Market coverage

Apple represents approximately 1/3 of the market.

In theory, an incumbent can deter efficient entry by targeting key customers, rather than the entire market.

But there are specific conditions for this to hold:

- 1) It must be unprofitable for the competitor to enter the market if it is excluded from supplying the targeted key customers
- 2) The competitor must not be able to effectively compete with the incumbent for the targeted customers, even though it is as-efficient.

The underlying mechanism for the second condition must result from an **asymmetry between the incumbent and its rival that makes the rival vulnerable** (e.g. sunk costs of incumbent, non-contestable demand and economies of scale, financial constraints...).

Market coverage

Why would a competitor (Intel) not be able to effectively compete if 2/3 of the market remain available?

Commission seems to see Apple as a trend-setter, whose leadership is able to influence the whole industry:

“Apple is also a leading smartphone and tablet manufacturer, which can influence other customers' and manufacturers' procurement and design choices. By making sure that rivals had no chance to compete for any of Apple's important business, Qualcomm's conduct had an effect on the LTE baseband chipset market as a whole.”

“They were also denied business opportunities with other customers that could have followed from securing Apple as a customer.”

But still not clear why an as-efficient competitor could not win other customers if it doesn't supply Apple. Here there is no co-branding, and why wouldn't other smartphone manufacturers use Intel if it is cheaper?

What does the FTC complaint say about this?

129. *Apple is a particularly important OEM from the perspective of a nascent baseband processor supplier and confers benefits on a nascent supplier that make the supplier a stronger contender for other OEMs' business.*

- a. *Apple sells large volumes of premium handsets that require premium LTE baseband processors. These processors ordinarily command **higher prices and margins** than lower-tier baseband processors. Supplying Apple helps a nascent supplier to achieve a scale of business that confers research-and-development flexibility, among other things.*
- b. ***A nascent supplier learns directly from engagement with Apple's engineering teams and this engagement improves the supplier's baseband processor offerings.***
- c. ***A nascent supplier achieves **technical validation** by demonstrating its ability to meet **Apple's demanding technical requirements**.***
- d. ***A nascent supplier engaged by Apple can **field-test its processors through global launches** that require real-world work with network operators and infrastructure vendors.***
- e. ***A nascent supplier obtains a **reputational halo effect** from selling to Apple. This reputational boost may help a supplier win sales at other OEMs.***

A dynamic story?

According to the FTC complaint:

“When Apple sought relief from Qualcomm’s excessive royalty burden, Qualcomm conditioned partial relief on Apple’s exclusive use of Qualcomm baseband processors from 2011 to 2016. Qualcomm’s exclusive supply arrangement with Apple denied other baseband processor suppliers the benefits of working with a particularly important cell phone manufacturer and hampered their development into effective competitors.” (8)

“The agreements significantly impeded the development of other baseband processor suppliers into effective competitors to Qualcomm.” (130)

Is the dynamic story more realistic than the static story?

Recall that Intel now supplying Apple.

So it appears Intel was still able to develop despite the exclusivity...

As efficient competitor test

The Commission rejected the AEC test submitted by Qualcomm:

“The Commission also assessed and rejected a "price-cost" test submitted by Qualcomm. The Commission concluded that the results of this test failed to support Qualcomm's claim that its exclusivity payments were not capable of having anti-competitive effects.”

Commissioner Vestager: *“Qualcomm also did its own as efficient competitor test, which it said showed that competitors could match Qualcomm's rebates. But there were serious problems with the way that test was done. So it didn't actually prove that the payments were harmless.”*

The Commission doesn't say it did its own AEC.

“Qualcomm paid billions of US Dollars to a key customer, Apple, so that it would not buy from rivals. [...] This meant that no rival could effectively challenge Qualcomm in this market, no matter how good their products were.”

But how can the Commission reach this conclusion without doing an as-efficient competitor test?

One should normally want to assess **to what extent Apple's demand is contestable**.

Non-contestable share of the market

The Commission doesn't mention non-contestable share of Apple's demand in its press release:

- **What** was it really that Intel couldn't do?
- **Why** was it essential to have at least Qualcomm on at least part of the demand?
- And **how large** is this part of Apple's demand?
- **iPhone/iPad?**
- **Role of patents?**

The **FTC complaint** considers there was a non-contestable share, but doesn't explain it either:

*“Although a price-cost test is not required to assess the competitive effects of Qualcomm’s agreements with Apple, the penalties under these agreements are sufficiently large that, if they were attributed as discounts to the price of Qualcomm baseband processors **reasonably contestable by a Qualcomm competitor**, the resulting price of Qualcomm processors would be below Qualcomm’s cost.” (125 c)*

Internal documents

Internal documents from Apple appeared to play an **important role in the Commission's investigation** (and more so than an AEC in this case):

“[...] internal documents show that Apple gave serious consideration to switching part of its baseband chipset requirements to Intel. Qualcomm's exclusivity condition was a material factor why Apple decided against doing so, until the agreement came to an end.”

But **is this enough**? Unless completed by additional information, such internal documents don't say anything on:

- **whether the competitor is as efficient.**
- **whether the offers received by the competitor were close to cost.**

Also, it appears that such documents take an e-post rather than ex-ante perspective. One should also inquire whether an as-efficient competitor could have effectively competed and replicated Qualcomm's offer in 2013 (rather than in say 2015).

Duration

“In 2011, Qualcomm signed an agreement with Apple, committing to make significant payments to Apple on condition that the company would exclusively use Qualcomm chipsets in its “iPhone” and “iPad” devices. In 2013, the term of the agreement was extended to the end of 2016.”

The Commission considered that the **duration** was sufficient for the conduct to be **deemed excessive**.

Commissioner Vestager: *“without the exclusive deal, the market has opened up. But for several years, consumers lost out on the benefits of competition – and the fine that we imposed reflects that.”*

However, **Intel is now supplying Apple** (for around half of its chipsets). This suggests that the exclusivity period (possibly impacted by the Commission’s investigation) **didn’t prevent Intel from becoming an effective competitor**.

Therefore, it may be argued that the exclusivity period should not be seen as excessive...

Buyer power

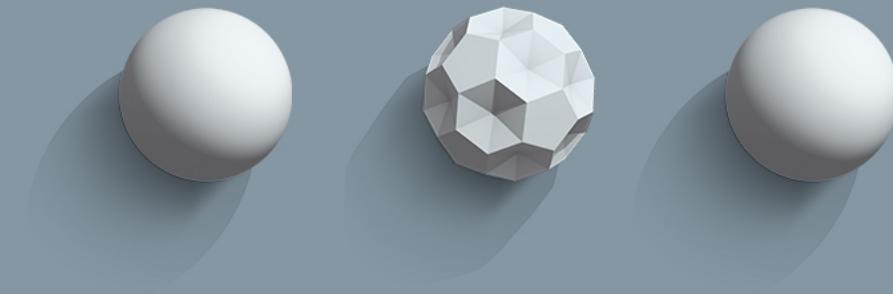
Commissioner Vestager: “[Loyalty rebates] can make it hard to break into the market. Because it locks customers into an exclusive relationship, even when rivals could offer better products for less. It leaves the market frozen, with no reason for anyone to innovate and come up with better, cheaper products. And so in the end, consumers can pay a very high price.”

Why would Apple agree to this?

- Apple is as large a sophisticated buyer as one could imagine. Why would it agree to be locked into an abuse exclusive relationship, resulting in more expensive and less innovative chips?
- Apple’s primary interest should be to have effective and innovative chips to maximize the profits it generates with its smartphones.
- The argument based on downstream competition allowing OEMs to be captured by their supplier doesn’t seem to apply here.
- Could Apple develop the chips in-house if it were faced with such a situation?

Conversely, if Qualcomm compensates Apple with a profit sacrifice to prevent competitor entry, how would such sacrifice be recouped?

Conclusion



Commission suggests that its approach is consistent with the Intel judgment. Yet, based on the information that is currently public, the Commission **doesn't appear to consider it necessary to conduct an AEC test** to assess Qualcomm's exclusivity rebates.

In my view, this **doesn't accord with spirit of the Intel judgment**, which very much emphasizes that article 102 TFEU is not supposed to protect less efficient competitors. At least, one would then **need to have a coherent story about anticompetitive effects** (explaining why supplying Apple is necessary for entry, and why as-efficient competitors couldn't effectively compete with Qualcomm).

This story does transpire from currently (limited) available information on the case. **Practical implication** in the meantime: dominant companies need to be extra careful with **exclusivity rebates to key customer(s)** (even if they represent a limited share of the market). But of course one shouldn't forget that such exclusivity rebates may also lead to real **efficiencies** (e.g. when relation-specific investments are needed) and allow firms to compete intensely for the entirety of a customer's requirement.

London

Tel +44 (0)20 7664 3700
8 Finsbury Circus
London EC2M 7EA
United Kingdom

Brussels

Tel +32 (0)2 627 1400
143 Avenue Louise
B-1050 Brussels
Belgium

Munich

Tel +49 89 20 18 36 36 0
Palais Leopold,
Leopoldstraße 8-12
80802 München
Germany

Paris

Tel +33 (0)1 70 38 52 78
27 Avenue de l'Opéra
75001 Paris
France

www.crai.com/ecp

Raphaël De Coninck, PhD

Vice President
Head of the Brussels Office
rdeconinck@crai.com
+32 (0)2 627 1401
+32 (0)492 738 010



Raphaël De Coninck, PhD
26 March 2018

CRA Charles River
Associates