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# A retrospective on Michelin I, Michelin II and BA/Virgin

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*Disclaimer: the author has been involved in a variety of cases and advocacy work related to rebates and discounts, both in private practice and in public authorities. However, the views expressed in this presentation are the author's only and do not represent the views of any past or current clients of Positive Competition, or of any institution which have employed the author.*

# Nonlinear prices: how do they look like and why?

- Terms like “retroactive” or “loyalty enhancing” are not proper economic terms. Economists would rather classify prices according to their dependencies:

1. Prices that are related to the identity of the buyer.
2. Prices related to the quantities bought from competing suppliers (this includes exclusivity conditions and market share thresholds).
3. Prices related to the quantities purchased (such aspect is generally referred to as “not conditional” by economists).

- A particular price system can have the three features at the same time and all aspects should be assessed together.

- The optimal tariff will depend on the type of issues the tariff intends to solve.

- It will also depend on the type of information that is available and can be put in a contract.
  - If prices have to be based on general terms of sales, difficult to have completely different price structures.
  - It is necessary to alter the *shape* of a general tariff to provide different price structures to different buyers.
  - Useful for instance when factors are not observed (e.g. sales effort) or cannot be contracted upon (downstream prices).

# Nonlinear prices: how do they look like and why?

- Nonlinear prices expose buyers to different parts of the tariff. This is helpful when:
  1. Customers have different characteristics.
  2. Buyers have the ability to behave in qualitatively different ways.
     - Exposing buyers to different kinds of prices gives them the incentives to self-select.

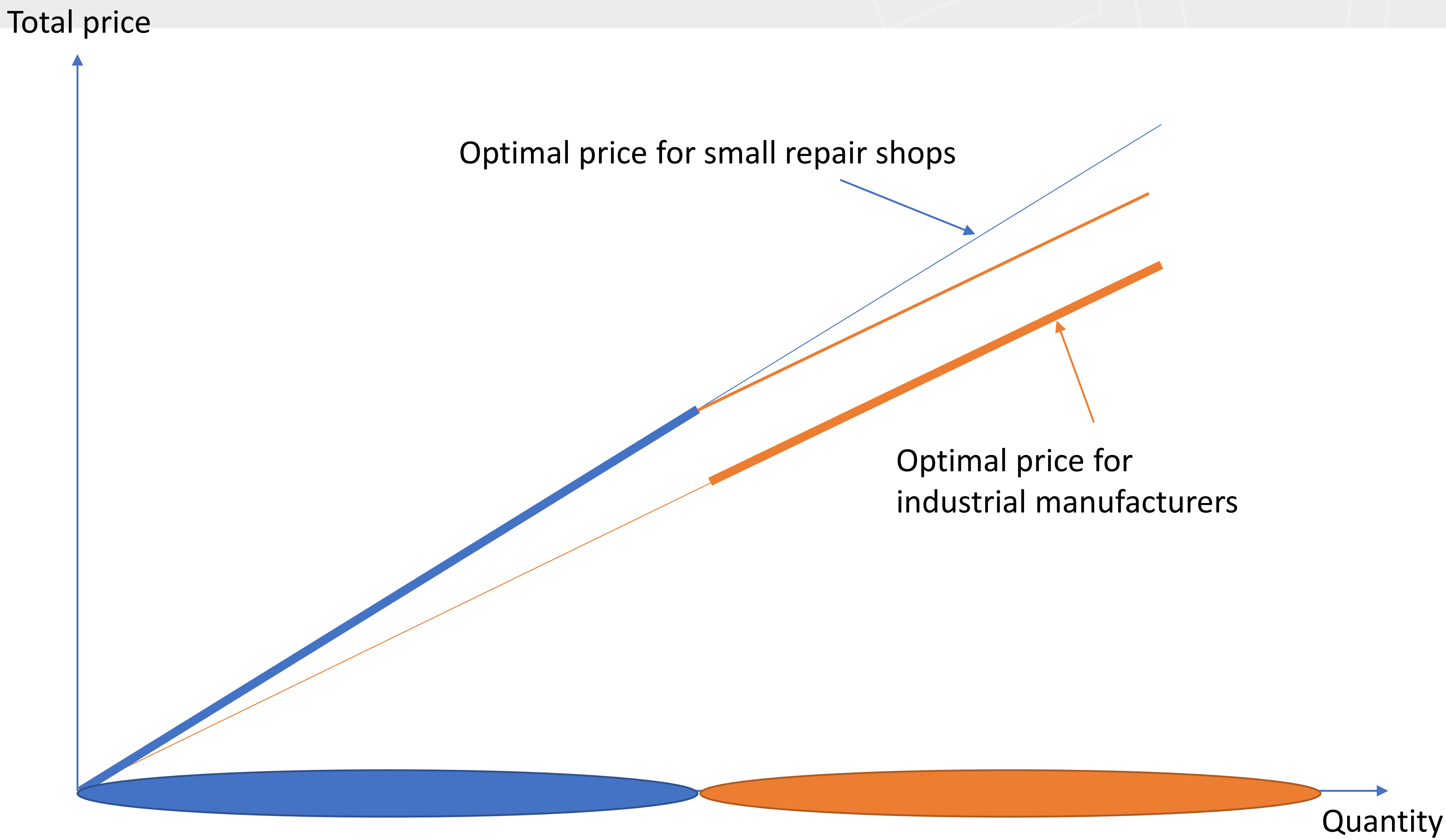
- The purpose of nonlinear tariffs can correspond to two broad categories.
  1. Prices intended to answer to asymmetric demands and competitive conditions ("price discrimination").
  2. Prices that intend to modify the strategic decisions of the buyer on factors that affect the supplier. ("alignment of incentives")

- Different motives and market circumstances will lead to different shapes
  - Some of them will show a discontinuity (and could be improperly referred to as "retroactive").
  - EU case law has also (wrongly) emphasised that this leads to negative prices and suction effects, which would necessarily correspond to an intent to foreclose.
  - While such suction effect could very well be intentional…
  - …this could also be a by-product of the necessity to design tariffs with different levels and slopes.

# Price discrimination

- Customers may have different demand, outside options or bargaining powers.
- Being able to propose different prices to different customers is always more profitable for sellers. The effects on buyers are more ambiguous.
- Economic theory regards price discrimination that allows a producer to increase its total sales as likely to be welfare enhancing (compared to uniform pricing).
  - In this context, if price discrimination can increase the total output sold on the market, it will benefit both sellers and final consumers (important when fixed costs are large: “Ramsey pricing”).
- Price discrimination can also be a response to competitive pressure.
  - A seller may not find it profitable to reduce their price uniformly.
  - This logic could apply either to different customers or to different parts of the demand of a given customer.
- On balance, the benefits of price discrimination to consumers depend on the level of sales with uniform prices and the strength of competition.
- Price discrimination could require any type of nonlinear prices, including “retroactive rebates”.

# Price discrimination



# Alignment of incentives

- The simplest type of misalignment of incentives is double marginalization.
  - Requires significant market power upstream and downstream.
  - Mostly emerges due to linear pricing when downstream market power is present.

- Non-linear prices can also be useful in a wide array of vertical issues.
  - Align the distributor's and the sellers' incentives and induce forms of vertical cooperation that benefit all parties, including consumers.
  - When demand is uncertain or bought quantities are hard to relate to efforts: need of explicit conditions.
  - These issues are more or less likely to be present in different circumstances.

- Such mechanisms might align incentives *ex-ante* but limit *ex-post* competition.
  - There seems to be a certain reluctance of EU Courts to acknowledge, at least explicitly, this ex-ante/ex-post tradeoff (more generally in verticals).
  - This general reluctance is unfounded in economics: firms invest in all sorts of intangible assets (call it brand, relationship, etc.).
  - This reluctance is inconsistent with the essential facility doctrine as there is no reason to treat investments in tangible and intangible assets differently.

# Building blocks for an effect analysis

- We discuss in the report a large number of mechanisms (i.e. *theories of harm*) through which nonlinear prices can lead to anticompetitive foreclosure.
  - They all have different features and there is no one size-fit all for their assessments.

- Economic literature and experience currently point towards clear sources of at least potential pro and anticompetitive rationales for all types of nonlinear prices.
  - Various legal systems might choose slightly different legal standards depending on aversion for T1/2 errors.
  - However, they should be based on similar principles.
  - Standards have to be fair and symmetrical.

- The assessment should first identify a particular theory of harm.

- Then, the assessment should be based on features that
  1. are at least *negatively* correlated with features that made procompetitive rationales more or less likely; or
  2. are *positively* correlated with features that makes this theory of harm more likely.

# Theories of harm that require a significant direct profit sacrifice

- The main issue with anticompetitive foreclosure is that it costs more to society than it brings to dominant companies.
  - It is not normally profitable to just “pay-off” all customers.

- The simple solution is to just pay a handful of strategic customers.
  - The theory was developed explicitly with naked exclusivity in mind.
  - Looking at the shape of the contract simply does not help: there are small rebates and large discounts.

- Structured rule of reason could look like:
  1. The rebates or discounts target customers that are particularly strategic for competitors to enter or expand; and
  2. These strategic customers get too much of a good deal
  3. Is there something else going on with these customers?

# Theories of harm that do not require a significant direct profit sacrifice

- There also exist many other theories of harm that don’t require such significant levels of sacrifice.
  - Assessing whether rebates are “large” is not the most relevant.
  - They are more sophisticated and rely on various assumptions.
  - For instance, they *typically* require that a large share of customers are covered and not only strategic ones.
  - They also *typically* require a strong level of commitment to the tariff.

- There is no reason to believe that these theories of harm are likely in most markets and circumstances.

- However, these theories rely on assumptions that can be tested:
  - If one really believes that buyers’ coordination is the issue, one should be able to find evidence in internal documents.
  - Same if one believes that dealers don’t switch to alternative suppliers because the rent would be dissipated by downstream competition.

# Back to the focus cases

- With what we now know about pro and anticompetitive effects of nonlinear prices
  1. Are there reasons to believe that Michelin and BA had plausible procompetitive rationales to put these systems in place?
  2. What was the most likely theory of harm (if any) and did the Commission assess it properly?