Michelin II – The treatment of rebates*

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1. Introduction

In 2001, the European Commission found that the French firm Michelin had – via its various types of rebates - abused its dominant position in the French markets for new replacement tyres and retreaded tyres for heavy vehicles, and imposed a fine of EUR 19.76 million to Michelin.[2] Two years later, the Court of First Instance upheld the Commission's Decision in its entirety.[3]

In many respects, this case is exemplary of the strict formalistic approach followed in abuse of dominance cases by the European Commission and the Community Courts, which severely limit the possibility of dominant firms to resort to certain business practices, such as exclusive dealing, rebates, tying. Indeed, the EU case law has so far disregarded the actual effects of the allegedly abusive practices (the Commission does not need to prove that exclusionary effects have indeed taken place, nor does it need to show that consumers have been hurt), the mere possibility that they could distort competition being enough for a finding of infringement of article 82 of the Treaty. As a matter of fact, *Michelin II* is even stricter than previous decisions and judgments because for the first time it is found that a dominant firm cannot even resort to pure (non-individualised) quantity discounts,[4] a practice until then accepted by the Courts.

Perhaps, though, the very fact that it pushed a formalistic interpretation of article 82 to its limit, will paradoxically and unintentionally make Michelin II a judgment which will contribute in a positive way to European competition law. This judgment made it apparent that in abusive cases economic, effects-based considerations are completely absent, and contributed to open a debate on how to reform article 82 policy.[5]

This chapter will be organised as follows. In Section 2 I will briefly describe the markets at hand, and summarise the commercial policies followed by Michelin. In Section 3 I will

[2] Decision 2002/405 of 20 June 2001, published in the Official Journal of the European Communities on 31 May 2002.

[3] Case T-203/01, Manufacture Française des pneumatiques Michelin v. Commission, Judgment of the Court of First Instance of 30 September 2003.

[4] Unless it can show that such discounts can be justified by per-transaction savings, see below for a discussion.

[5] At the moment I am writing, the European Commission is still in the midst of this process of reform, and – although it claims that it intends to undertake a more economics-based approach – it is not clear to what extent this objective will be followed in practice.

report the main arguments followed by the European Commission and the Court of First Instance. Section 4, which is the main section, will contain my own assessment of the case:[6] in particular, I will criticise the fact that rebates may be found per se abusive, without any need of formulating a coherent theory of foreclosure, without looking at any evidence of the actual effects of the practices at issue, and without considering possible pro-competitive effects.

2. A short description of the case

In this Section, I will first briefly describe the relevant markets and then summarise the commercial policies that made the object of the investigation.

The markets

The discussion of the product and geographic markets is important to understand the case, but will be kept short here because it is not particularly controversial.

There exist several different types of tyres, and there is consensus among the parties that tyres for trucks and buses are not substitutable with tyres for cars, vans, tractors and so on. There is also a difference between new tyres which are sold in the original equipment market (directly to truck and bus producers) and *new tyres sold in the replacement market* (buyers are final consumers, which mainly purchase at specialised outlets). This case concerns the latter market only..

A customer who needs to replace his truck or bus tyres may either buy new tyres or *retreaded tyres*:[7] this is because the tread of a worn tyre casing can be renewed. There exist two different processes for retreading tyres: mould-cure, prerogative of tyre manufacturers, and pre-cure (by middle-size firms). Mould-cure and pre-cure retreading are considered close substitutes.

The markets for new replacement tyres and that for retreaded tyres are the two relevant product markets of this case. They are considered distinct because apparently the quality

[6] Michelin II, and the EU policy on rebates, are also discussed in two excellent articles, Spector (2005) and Waelbroeck (2005).

[7] 53% of the replacement market for truck tyres is composed of new replacement tyres, and 47% of retreaded tyres.

of new tyres is perceived as superior (more reliable) to that of retreaded tyres, which are cheaper, being sold at less than 50% of the price of new 'brand' tyres; but new 'white brand' or 'third-line' tyres also more expensive than retreaded tyres.[8] The Commission Decision does not put it in these terms,[9] but we know that in order to define relevant markets we should use the available information to answer the SSNIP test question: could a hypothetical monopolist of new replacement tyres profitably raise prices by 5-10%? Only in this way could we appreciate the competitive constraint that the products exert to each other. From what is reported in the Decision, we do not have data to answer this question, but it is possible that the answer would be positive because of the higher reliability of new tyres.

Finally, the geographic scope of these product markets is considered to be France, given that the French market appears to have sufficiently distinct features from other markets which are considered not to exercise a competitive constraint on the French market.

The industry

The industry for new tyres is quite concentrated both in the world and in the EU, the first six producers accounting for around 75-85% of the markets. There are different leaders in different markets: at the world level (according to 1997 data referring to all types of tyres) Michelin and Bridgestone share the leadership with 18-20% of the market, followed by Goodyear (15%), Continental (8%), Sumitomo/Dunlop (6%), and Pirelli (5%).[10] In Europe, however (1995 data for all tyres) the leader is Michelin with 31% of the market, followed by Continental (17%),Goodyear (13%), Pirelli (9%), Bridgestone (8%), Sumitomo (8%). The relative competitive positions of the firms change further when different EU countries are considered, Michelin being stronger in France, Pirelli in Italy and so on.

[8] 'Third-line brands' are low quality tyres – often 'white brands' - produced in low-cost countries but sometimes also by major manufacturers. They still have a limited penetration at the time of the Decision.

[9] The Commission still defines the relevant markets by looking at price similarities, physical features of the products and so on. For a critique to this approach, see e.g. Motta (2004: chapter 3).

[10] Goodyear and Sumitomo merged in 1999, but the period of the infringement considered here was 1991 to 1998 included.

Public sources put Michelin's market share for new tyres in 1995 at 55-60% (no data are reported for the retreaded tyres market). Its leadership during the period 1991-1998 is stable even though the market share is decreasing (see also below).

As for production capacities, Michelin has 11 of the 19 production plants in France, the others being owned by Kléber (controlled by Michelin), Continental, and Dunlop/Sumitomo with 2 plants each, and Bridgestone/Firestone, and Goodyear with 1 each.

Specialised distributors have 75-85% of the truck segment for tyres, their position of strength being due to the fact that the choice, fitting and management of truck tyres requires technical knowledge. Probably due to this, there is a growing tendency for manufacturers to control distribution and vertically integrate.

Michelin owns the largest network among the 2225 specialised sales outlets (data refer to all tyres), the chain *Euromaster*, which is composed of 330 outlets;[11] while Sumitomo/Dunlop have 120 specialised outlets and Bridgestone/Firestone only 26.

As for the retreading market, Michelin does mainly mould-cure retreading, while its main rival, Bandag, which operates through a network of franchisees, does pre-cured retreading. Market shares for this market are not reported, although the Judgment indicates that the pre-cure retreading segment is growing (75% in 2002).[12]

Michelin's commercial policy

Michelin's commercial policy, central to this case, was composed of four elements. 1. The *general price conditions* for professional dealers, consisting of a list price ('invoicing scale') plus a system of rebates (quantity rebates, service bonus, progress bonus, individual agreements); 2. the so-called '*PRO agreement*'; and 3. the *'Club des amis Michelin'*, an agreement on business cooperation and assistance.

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[11] Interestingly, Euromaster sells not only Michelin tyres, but also competing brands. We shall come back to this point, which raises some doubts about the Michelin's alleged intention to exclude rivals (why selling competing brands, if Michelin intended to foreclose them?)

[12] The most common practice in France is 'custom retreading' (where the own tyres are retreaded), while in the EU 'standard-exchange retreading' is more common.

In what follows, I briefly describe each of these elements.

1 – General price conditions (1980-1996)[13]

A dealer buys (new or retreaded) tyres according to the official 'invoicing scale', and pays within 30 days of the end of accounting month. It then receives the total rebates as a lump-sum only at the end of February of the following year.
Let us analyse the various types of rebates.

i. Quantity discounts

Two grids – one for new tyres, the other for retreaded tyres - showing the percentages deductible from the list price for the entire turnover achieved represent the main quantity discount scheme. As one can see from Tables 1 and 2 below, the larger the volume of purchases of a customer the higher the rebate it can enjoy. For example, a buyer purchasing 10,000 FF of new tyres in 1995 will receive a yearly rebate of 8.5%, i.e. 850 FF. Seen from a one-year window, this effectively amounts to reduce the unit price paid by the buyer: if a tyre's list price is, say, 100, the fact of having bought 100 tyres through the year reduces the unit price of a tyre from 100 to 91.5. In other words, although it takes the form of a lump-sum payment which takes place once a year, this rebate amounts to a reduction of the unit price to be paid. If a buyer was able to anticipate correctly the exact amount of tyres he will buy, and apart from the possible cash effects (the rebate is obtained with a delay of some months), this scheme amounts to assigning a certain unit price to any intended total volume purchase.
However, it should also be noted that in case of some additional unexpected purchases, i.e., changes relative to the expected purchase volume, the effect at the margin is larger than it may appear at first sight. Consider for instance a buyer who decides to order an extra 10000 FF of tyres. This will bring the total amount purchased to 20000 FF, a threshold subject to a 9% discount. However, the effective discount is larger, since due to the new threshold met the buyer will also receive an extra .5% on the first 10000 FF

[13] Michelin changes its policy in 1997, after the entry into force of the French Law prohibiting selling at a loss. Since the policy followed in 1997 and 1998 contains similar features as the previous one, for shortness I do not describe it.

worth of tyres bought. Overall, therefore, the marginal purchase has a unit cost of 90.5 rather than 91. But the cost of an additional purchase may be even much smaller when a very small number of additional units allow the firm to reach a higher quantity threshold. For instance, if 9000 units command a discount of 7.5%, buying one additional unit would bring the discount on *all* units to 8.5%: if the list price of one unit is 100FF, the effective marginal cost of buying this extra unit would be 1.5 FF, which brings the actual discount on this extra unit to 98.5%![14]

[14] 100-(100x8.5%)-(9000x1%)= 1.5, where 100 is the unit price for the extra unit, 8.5% is the discount applied to this extra unit, and 1% the additional rebate granted on all the 9000 units previously bought.

T/O 95	**Rate**	**T/O 95**	**Rate**	**T/O 95**	**Rate**	**T/O 95**	**Rate**
<9000	7.50	172000	10.65	5855000	11.85	10660000	12.45
15000	8.50	241000	10.75	6242000	11.90	11170000	12.50
25000	9.00	492000	10.85	6604000	11.95	11730000	12.55
30000	9.25	757000	10.95	6934000	12.00	12520000	12.60
35000	9.50	1030000	11.05	7280000	12.05	13380000	12.65
45000	9.85	1306000	11.15	7640000	12.10	14314000	12.70
60000	10.00	1656000	11.25	8020000	12.15	15314000	12.75
80000	10.10	2100000	11.35	8415000	12.20	16385000	12.80
100000	10.20	2663000	11.45	8830000	12.25	17532000	12.85
118000	10.35	3376000	11.55	9260000	12.30	18792000	12.90
142000	10.50	4280000	11.65	9710000	12.35	20145000	12.95
		5136000	11.75	10180000	12.40	22000000	13.00

Table 1: Scale of quantity rebates, 1995: discount rate offered for a turnover of up to a certain amount. Source: CFI Judgment, para. 69.

Retreading Turnover Excluding VAT	Discount rate
< 7 000	0
7 000	2
7 400	3
8 000	3.5
10 800	4
14 700	4.50
19 600	4.75
29 400	5
49 000	5.1
88 200	5.2
166 600	5.3
323 400	5.4
637 000	5.5
1 127 000	5.6
1 813 000	5.7
2 499 000	5.8
3 185 000	5.9
3 920 000	6

Table 2. Scale of quantity rebates for retreated tyres (1995). Source: CFI, para.70.

ii. Service bonus

The main objective of this type of rebate is to provide an incentive to the specialised dealer 'to improve his equipment and after-sales service'. To qualify, it was necessary a minimum turnover with Michelin (the threshold passed from 160,000 FF in 1980 to 45,000 FF in 1996). The size of the bonus depends on the dealers' compliance with commitments they have taken in a number of areas; each commitment gives a number of points; the more the points a dealer scores the higher the bonus, which is up to 1.5% until 1991, and up to 2.25% in 1992-96.

The criteria used to assign points include features related to the quality of the services provided by the dealers, such carrying out *staff training*, having *certain machinery and know-how*, and the level of *quality of the facilities*; features related to the dealer's behaviour with clients, such as supplying customers with *new Michelin products*, promoting and advertising them; and providing Michelin with detailed *information* (mileage of tyres, performance, statistics on sales, also comparing Michelin and competitors) to help it plan its production. As for *retreading*, points are achieved by providing roadside assistance for trucks; by showing knowledge about how to sort casings; and by having Michelin tyres systematically retreaded by Michelin.

iii. Progress bonus

This bonus rewards dealers who agree to commit in writing at the beginning of the year to exceed a certain minimum base of purchases (which is fixed by common agreement between the dealer and Michelin, and which depends on various factors), and manage to exceed it.

The system changed over the years. In 1995-96, it specified, for sales between 30-999 tyres: 12% of the amount by which the base is exceeded, if the progress was lower than 20%; and 2% of the *aggregate* turnover if the progress was higher than 20%. For sales above 1000 tyres: 15% of the amount by which the base was exceeded, if progress was lower than 20%; and 2.5% of the aggregate turnover if progress was higher than 20%. If the base was reached but not exceeded, a bonus of 0.5% of the turnover was granted.

iv. Individual agreements

This scheme was applicable to dealers who reached the maximum amount in the quantity discounts table above (amounting to a turnover of 22m FF in 1995), who could then sign a cooperation agreement with Michelin. The scheme required dealers to commit to provide technical information and after-sales service; help launch Michelin products; submit forecasts; get regular supplies from Michelin. The benefits foreseen were: an extension of the discount tables (up to 2% additional rebate); a favourable system to calculate the progress bonus; and an extension of the payment deadline (e.g., 60 rather than 30 days).

2. The 'PRO Agreement'

This scheme offers a dealer a rebate for each tyre given to Michelin for retreading. In exchange, the dealer commits to a truck progress bonus, and will have Michelin retread all the Michelin truck tyres which have reached the legal limit for the tread wear.
This scheme contains an element of tying, in that the maximum number of bonuses a dealer can achieve is limited by the number of new Michelin tyres bought during the previous year (and the bonus is conceived not as a cash payment but as a credit towards buying new Michelin tyres).

3. The Michelin friends' club

The "Club des amis Michelin" is an agreement that Michelin signed (bilaterally) with a large number of sales outlets (375 in 1997, accounting for some 20% of the truck tyres markets). According to the agreement, Michelin helps the club members to improve their performance and professionalism; in return, members guarantee a certain level of 'Michelin temperature' (i.e., large enough volumes and market share).
More specifically, Michelin contributes to investment and training of the dealers; this includes a financial contribution, if a specific target is attained; but also the transfer of know-how in many areas; priority access to training courses (50% of courses at Michelin's training centre are reserved t members); transmission of data on market trends; and exclusive distribution of BF Goodrich car tyres.

Members' commit to communicate balance sheets, and provide Michelin with disaggregate sales statistics (but Michelin also carries out individual financial analyses, and helps members to find solutions to their financial problems). They also permit Michelin to carry out analyses of the outlets in areas such as staff qualification and competence, quality of services and sales promotions, sales facilities; they promote Michelin products by displaying advertising material, carrying product information, and taking part in advertising campaigns; they commit 'not to divert customer demand away from Michelin'; carry enough stock of Michelin products so as to meet customer demand immediately; have their first retreading made by Michelin; play an active role in truck tyre sales and services.

3. The Commission's findings

To prove that a firm has abused a dominant position, i.e. that it has infringed article 82 of the Treaty, the Commission first has to find the firm is dominant in a given relevant market, and then has to show the abusive nature of the firm's practice.

Michelin's dominance

In this case, the relevant markets are defined (see above) as the (i) new replacement truck tyres in France and the (ii) retreaded truck tyres in France. The Commission finds that Michelin has a stable leadership in these markets, with market share above 50% (however, we know from the CFI judgment that Michelin's share is decreasing over time). Moreover, its strength is also due to its technological lead and expertise; its strong reputation; the wide range of its products; and its strength in commercial and technical services, demonstrated by its leading position in the French distribution channel (where it owns directly sales outlets, and has strong links with a large number of other outlets thanks to the *Club des Amis Michelin*).

These points of strength should therefore support the idea that Michelin is dominant, i.e., it has considerable market power: in other words, it can keep prices well above cost because little demand would switch to rivals and importers, that according to the

Commission are not competitive enough. Further, the Commission argues that buyers do not have much power, as specialised dealers "must deal" with Michelin, else they would lose credibility (since clients would ask for Michelin's products).

The issue of dominance may deserve some further analysis (Michelin's market share appears to decrease over time, even if we do not have precise data on this;[15] further, the Commission itself indicates at para. 212 that in the last decades, new firms have entered the French market and have become more competitive), but the absence of data in the Decision suggests that we should focus on other issues.

One element that I would like to point out for further discussion below, is that the Commission stresses strong competition among dealers and indicates it as an element which compels dealers to accept Michelin's rebate schemes:

> "Competition between dealers [is] very keen and margins small (in 1995, for example, the average operating margin of French specialised dealers was 3.7% of their turnover). Under this pressure, independent dealers are constrained to obtain the best terms possible when purchasing Michelin products, especially as regards truck tyres. In order to preserve the competitive edge on which their survival probably depends, dealers do not hesitate to take part in the majority of 'programmes' and 'agreements' that they are offered, if as a result they can benefit from rebates or other additional economic advantages. Very slight variations in the rebate rates can prove to be essential to the dealers, who will do their best to make the most of them." (Commission Decision, Para 206.)

The abusive nature of Michelin's commercial policy

[15] At para. 176 of the Decision, the Commission reports some publicly available estimates which put Michelin's share in the new replacement tyres for trucks in France at 55% in 1995 and 51% in 1996. The strongest competitors appear to be Dunlop (9% in both years) and Bridgestone/Firestone (whose share drops from 12.5% in 1995 to 9% in 1996); Goodyear (6.5% in 1995 and 7% in 1996) and Continental/Uniroyal (5% in 1995 and 6.5% in 1996) and Pirelli (3% in both years) follow, while minor suppliers (including third line) grow from 9% to 14.5%.

According to the Commission, when faced by new entrants and stronger rivals, Michelin has adopted a complex system of rebates and discounts to maintain dominance, thus leading to the finding of Michelin's infringement of article 82 and the imposition of a large fine. In what follows, I review the Commission's arguments, delaying my own considerations to the next Section.

General price conditions

Quantity discounts are criticised by the Commission because the purchase of some additional units may determine reaching of a higher quantity threshold and thus entitle the buyer to a larger rebate on *all* units (additional and previously bought). Such rebates (which indeed may determine a very low price associated with marginal purchases, as discussed above) would therefore create a strong incentive to buy additional units from Michelin, determining a *loyalty-inducing effect*.

The Commission also criticises, following an established case law, the fact that the discounts would not reflect economies of scale. This is because the case law of the Community Courts only allows discounts which are justified by *transaction-specific savings*: if a firm can show that the unit cost of supplying in one particular transaction a particular buyer with 100 units is lower than the cost of supplying the same buyer with, say, 50 units, then a discount to that buyer would be justified. But claiming that a rebate scheme would induce one or more buyers to purchase more over several transactions, which in turn allows the firm to reduce unit costs of production, would be considered a generic claim which does not qualify as efficiency gain.

The Commission also judges the scheme *unfair*, because: rebates are not paid until February on the following year, which would determine cash flow problems for buyers, and even oblige them to operate at a loss until the rebate is paid; dealers have to negotiate the progress bonus with Michelin before they have received the quantity rebates for the previous year, which would put them "in a weak psychological position during negotiations" (para. 223); buyers would suffer from uncertainty, as until the end of the year they do not know the actual cost of inputs.

I always find it difficult to evaluate fairness arguments in connection with competition policy issues, but I would none the less like to stress the paternalistic approach of the

Commission, which seems to view buyers (which in this case are firms, not final consumers) as being unable to make forecasts and organise their business.
Finally, according to the Commission this system would have market-partitioning effects, because rebates are applied only to purchases from Michelin France, thereby making parallel imports difficult, as tyres bought outside France do not qualify for the thresholds established by the rebate schemes. (Recall that preventing parallel imports, that is arbitrage between different EU member states, is a very serious violation of EU competition law.)
Curiously, it is in this section devoted to parallel imports, that the Commission goes the closest to formulating a theory of foreclosure in the Decision:

> "…thanks to its market shares, Michelin was able to absorb the cost of these rebates, while its competitors were unable to do likewise and therefore had to either accept a lower level of profitability or give up the idea of increasing their sales volume."(Commission Decision, para. 241)

The *service bonus* scheme shows according to the Commission similar abusive features as quantity discounts. In particular, it is u*nfair*, because: a) it is subjective (Michelin has a wide margin of discretion in assigning 'points' to buyers); b) it asks dealers to provide market information, which would not be in their interest and for which they would have no return (e.g., in form of market studies); c) subjectivity is inevitably a source of discrimination (recall that a dominant firm may not discriminate among customers, discrimination being abusive). It is also *loyalty-inducing*, in that reaching a minimum turnover is necessary for a dealer to qualify and strengthen links with Michelin; and because it assigns points if Michelin tyres are systematically given to Michelin for retreading, which effectively amounts to a tying practice.

As to the *progress bonus*, (as well as the 'achieved target bonus' which replaces it in 1997) it is particularly abusive because it is *loyalty-inducing*, by pushing dealers to buy more than previous years (or meet the target), thus denying sales to rivals; and *unfair*, because: a) it is discriminatory (two dealers who buy the same quantity but have different bases get different rebates); b) it “creates insecurity” in dealers (they do not know if they will get the bonus).

Individual agreements are equally abusive, because they give extra incentives to large dealers, and put pressure on them to buy only from Michelin, so that they can reach the highest rebates.

The other rebate schemes

Similar arguments as to those made above are also used by the Commission to explain why the remaining rebate programmes are abusive.

The ‘*PRO agreement*’ contains a ‘double-tying’ component, since Michelin casings have to be sent exclusively to Michelin for retreading. The effect of this practice is abusive – according to the Commission - because Michelin would use dominance on the new tyres market to strengthen it in the retreading market and vice versa. Further, the fact that the bonus is limited to the number of new Michelin tyres sold during the previous year (no matter how many tyres are sent for retreading) would imply that dealers are discouraged from buying rivals’ new tyres, for the following year the bonus would be lower.

As for the *Michelin’s Friends Club*, it would also contain abusive obligations, in that dealers: i. need to achieve a certain ‘temperature’ (i.e., proportion of sales from Michelin); ii. cannot divert spontaneous customer demand away from Michelin; iii. need to carry a sufficient stock of Michelin products to meet demand immediately. These obligations would aim at eliminating competition and maintaining dominance, with an effect similar to a ‘fidelity clause’, further aggravated by the fact that Michelin has also an integrated network which ensures it a large market share. Finally, the Commission also objects to the ‘excessive’ monitoring of dealers’ business, which Michelin would use to control dealers and make sure they do not buy from its competitors.

There is no doubt that Michelin’s rebate programme contains some elements of aggressive competition, as we shall discuss below. For the time being, it is important to underline that the Commission’s arguments are either non-economic in nature (the alleged unfairness of the practices followed by Michelin), or are insufficiently motivated. As we shall discuss below, it is conceivable that rebates (as tying and exclusivity provisions) may exclude rivals, but here there is neither an attempt to explain why foreclosure should occur, nor a presentation of evidence which indicates that foreclosure was indeed taking place, not to mention the complete absence of possible pro-competitive justifications for the rebates or of an assessment of the effect of such practices upon consumers.

The Commission's Decision is appealed by Michelin, but the Court of First Instance upholds the Decision, and accepts all the Commission's arguments (which in many cases just followed an established case-law).

The main element of novelty in the Judgment is the fact that for the first time the Court rejects the use of pure quantity discounts. According to the Court, they induce loyalty because the rebates were calculated on the overall turnover, and are abusive because not justified by cost savings:

> "…a rebate system in which the rate of the discount increases according to the volume purchased will not infringe Article 82 EC unless the criteria and rules for granting the rebate reveal that the system is not based on an *economically justified countervailing advantage* but tends, following the example of loyalty and target rebate, to prevent customers from obtaining their supplies from competitors (…)" (para. 59 of the Judgment, italics added)
>
> "A quantity rebate system has no loyalty-inducing effect if discounts are granted on invoice according to the size of the order. If a discount is granted for purchases made during a reference period, the loyalty-inducing effect is less significant where the additional discount applies only to the quantities exceeding a certain threshold than where the discount applies to total turnover achieved during the reference period." (Para. 85 of the Judgment)

But perhaps the most striking, and potentially important, element in the Judgment is the way in which the CFI dismisses Michelin's argument that the rebate system did not have any effect on competition, as M's market shares and prices were falling:

> "[…] In any event, it is very probable that the falling in the applicant's market shares (recital 336 of the contested decision) and in its sales prices (recital 337 of the contested decision) would have been greater if the practices criticised in the contested decision had not been applied." (para. 245 of the Judgment)

As one can immediately see, the Court's arguments may completely undermine an effects-based approach: for any evidence that a firm may produce in support of its claim that rivals have not been hurt, and/or that consumers have benefited from the practice, the Court could always counter such evidence with an argument (which does not need to be supported by evidence) that rivals and consumers would have benefited even more had the dominant firm not engaged in the (abusive) business practices at hand.

An economist's assessment of Michelin II

Most business practices which are potentially exclusionary – and this holds not only for rebates, but also tying, exclusive dealing, refusal to supply - may also have pro-competitive effects. Since the objective of competition policy is not to protect competitors, but to protect competition and increase welfare, economic analysis suggests to undertake the following four-step approach in order to find whether a firm has engaged into abusive practices: first, find whether the firm is dominant, that is if it has considerable market power; second, identify whether the practice has indeed possible anti-competitive effects, including the formulation of a coherent hypothesis about the strategy of the firm; third, analyse the possible pro-competitive (efficiency) effects of the practice at hand; fourth, balance the anti- and pro-competitive effects, that is, carry out an assessment of the net effects on consumer (or total) welfare.[16]

[16] See for instance Motta, 2004. The particular way in which the test is proposed does not matter much. The important thing is that an explicit analysis of both the anti-competitive and the pro-competitive effects, and an estimation of their net effect on welfare, is carried out. Gual et al. (2005) suggest that there is no need to separately show that the alleged violator has market power, but this is in my opinion a useful screening device, which has the further advantage of bringing the test in line with EU competition law.

The Commission and the Community Courts, instead, basically adopt a *per se* rule of prohibition of rebates (but also exclusive dealing and tying) by a dominant firm. They do not present a theory of why the dominant firm may use rebates so as to foreclose rivals, do not consider necessary to show any actual foreclosure, do not analyse the possible efficiency rationale behind the practices, and do not try to assess whether ultimately the practices would have harmed or benefited consumers.[17]

In what follows, I try to assess the Michelin II case from the perspective of the economic approach delineated above. However, I do not discuss the issue of dominance (which is simply assumed to be proved) ad focus instead on anti-competitive effects and the possible pro-competitive ones.

Do rebates have anti-competitive effects?

Rebates can be defined as discounts applicable where a customer exceeds a specified target for sales in a defined period. There are different types of rebates, according to the sales 'target' given to the customer. Rebates can be conditional (i) on increasing purchases; (ii) on buying only (or in a sufficiently high percentage) from the given supplier; or (iii) on buying over a given amount of units (quantity discounts). They can also be individualised or standardised.

Interestingly, Michelin's commercial policy included more or less the whole range of possible rebates. The *progress bonus* belongs to type (i), as it established a minimum turnover, which represented the base to measure 'progress', that is the extent to which the target was met or exceeded, in turn determining the discount. The *Michelin's friends club* was of type (ii), since it required a 'certain temperature', i.e., a sufficiently high volume and share of purchases from Michelin to qualify; the *service bonus* and the *individual agreements* also contained elements of type (ii) by requiring a certain minimum turnover to qualify (the scheme does not apply if sales are below the threshold); as for the *quantity*

[17] In the US, there is a very different approach, which considers rebates as "competition on the merit", and puts the burden to prove anti-competitive behaviour on the plaintiff. However, recent decisions such as *LePage* and *Dentsply* may signal a change. See Kobayashi (2006) for a discussion of the US policy on rebates.

discounts, they belong to type (iii), since the different discount rates were conditional on the purchase of different number of units (for any given amount bought during one year, one could easily compute the unit cost associated to it). Further, the rebates offered by Michelin can be either individualized (indeed, the Commission and the Court criticize the fact that both the *service bonus* and the *progress bonus* are discretionary and discriminatory, since two identical buyers can be offered different rebates), or standardized (quantity discounts are in principle identical to any costumer).

Conceptually, the first two types of rebates are similar to exclusive dealing provisions, in that they try to induce a buyer to purchase all (or most of) its inputs from the same supplier, either directly (specifying that a certain percentage or volume is purchased) or indirectly (by conditioning the discount to buying the same or increased number of units than in the previous year).[18]

In this perspective, we may rely on the literature on exclusive dealing to understand why rebates may foreclose rivals.[19] In particular, Rasmusen et al (1990) and Segal and Whinston (2000) have showed that if buyers cannot coordinate their purchase decisions and a new firm needs to secure a certain minimum number of buyers to operate efficiently, exclusive dealing allows an incumbent monopolist to exclude the rival.[20] Indeed, the incumbent monopolist just needs to induce a certain number of buyers to purchase exclusively from it, thereby preventing the entrant from achieving the minimum number of orders necessary to operate profitably, and effectively obliging all remaining buyers to buy from the incumbent as well.

Although there are some differences between rebates and exclusive provisions (unlike the latter, the former practice does not include any ex ante commitment on the side of the buyer), one could presumably formalize a story whereby an incumbent could use discounts conditional on buying more than in the past, or on buying at least a certain percentage of input needs, to prevent rivals from reaching a minimum size of its business.

[18] Indeed, such types of rebates have always been considered 'abusive' in the EU because they are said to amount to exclusive dealing, a practice which is not tolerated by dominant firms.

[19] See Motta (2004: Section 6.4) for a presentation of the literature.

[20] See also Bernheim and Whinston (1998). In their model, in which markets appear sequentially, an incumbent is able to use either explicit exclusive dealing provisions or a sort of quantity discount to exclude an entrant from the first market; since the entrant needs to sell in both the first and the second market to operate profitably, foreclosure will arise.

As for quantity discounts, it is not straightforward to see at first sight their exclusionary potential: how can an incumbent use non-individualised quantity discounts so as to exclude a more efficient firm? Note that – unlike exclusive dealing – under rebates there is no contractual commitment for the buyer to buy only from the incumbent: here the incumbent can offer only a price-quantity menu which can in principle be matched by the rival.

Karlinger and Motta (2006) take seriously the argument of the Commission and the Court of First Instance and show that it is indeed possible for an incumbent to exclude a more efficient rival, even if the latter can use the same rebate scheme.

In their model with buyers of differing sizes, the incumbent has an incumbency advantage given by an established customer base that the (more efficient) rival firm does not have. In order to be profitable, the rival needs to attract a certain minimum turnover, while the incumbent has already reached it.[21] In this model exclusion may arise even under linear pricing (because of miscoordination of buyers – if a buyer expects that all other buyers would buy from the incumbent, s/he would have no incentive to buy from the entrant, since its orders would not be sufficient to trigger entry). However, the authors show that quantity discounts have a higher exclusionary potential. To understand why, consider first the benchmark situation where the incumbent could make *explicit price discrimination*, and suppose that the entrant is not able to reach the minimum threshold size if it does not sell to the large buyers. In this case, the incumbent could break an equilibrium where the rival sells to all buyers by making a below-cost price offer to the large buyers, while recovering profits by imposing the monopoly price to the small buyers (who, failing the rival firm to achieve minimum size, would have no other possibility than to buy from the incumbent). Karlinger and Motta (2006) show that – unless the incumbent is considerably less efficient than the entrant – under price discrimination the only type of equilibrium arising in the game is the exclusionary one, where only the incumbent serves.

[21] The main model in Karlinger and Motta (2006) considers an industry with network externalities, and assumes that the entrant needs to achieve a sufficiently large number of buyers for them to derive utility from the consumption of the network product. Here, I am describing the mechanism of the paper assuming economies of scale in production rather than in demand, but the two are equivalent.

Next, observe that the incumbent can use this 'divide and rule' strategy even through *quantity discounts*, which are nothing else than a form of *implicit price discrimination.* Indeed, the only difference between a scheme which explicitly offers different prices to a small and a large buyer and a quantity discount scheme is that under the latter buyers have to self-select, i.e. can choose freely which offer to accept. However, provided that the price offers are not 'too imbalanced', so that a small buyer does not want to behave as if s/he were a large buyer, some price discrimination can still be achieved, thus determining exclusion, at least under some conditions.

Karlinger and Motta show that the more aggressive the pricing scheme (linear pricing is the least aggressive, since the firm cannot discriminate, followed by quantity discounts where in order to discriminate successfully the self-selection constraint of buyers must be satisfied, and finally by explicit price discrimination) the more exclusionary potential it has, that is the more likely that at equilibrium the incumbent operates in monopolistic conditions.

However, they also show that when comparing equilibria where exclusion cannot be achieved (for instance, if the incumbent is much more inefficient than the rival, or if the minimum threshold size needed by the entrant is small), the welfare ranking is exactly the opposite: the more aggressive the pricing scheme, the lower the prices at equilibrium, and therefore the higher the welfare outcome.

These results demonstrate the fundamental dilemma that one faces when establishing the policy towards rebates (and pricing schemes in general): by prohibiting dominant firms from using aggressive pricing policies (such as rebates), one lowers the risk that exclusion will occur; however, this would at the same time prevent competition from taking place, which will promote entry, but also higher prices.

Facing such a trade-off, different policy options are possible. (i) Always allowing rebates (or other 'aggressive' pricing policies), for instance by putting the burden of proving anti-competitive behaviour on the plaintiff and imposing a very high standard of proof (which, by and the large, has been the US case-law so far, at least until the *LePage* and *Dentsply*'s District Court decisions). (ii) Imposing a *per se* prohibition of rebates by dominant firms, which by and the large corresponds to the current EU policy. (iii) Use a *rule of reason* approach, which admits that rebates may be exclusionary, but also recognise that they can also be an instrument of market competition and determine important welfare gains for consumers. The third approach is certainly more difficult to implement because it calls for detailed investigations, but it is the only one which is consistent with economic analysis. If one decides to follow this route, one needs to carry out a detailed analysis of the case and understand to which extent in the case at hand it is sufficiently likely (rather than simply conceivable) that rebates might achieve exclusion of rivals.

Let us now come back to our case. We know that theory admits the possibility that the various types of rebates used by Michelin could be used for exclusionary purposes.[22] But how likely is it that in the facts of this particular case, rebates would have the effects of foreclosing rivals?

In all the models mentioned above, rebates (and exclusive dealing) are anti-competitive if they exclude competitors. But is it credible that Michelin's competitors would exit the market, or at least be relegated to small niche markets? From the description of the industry, we know that Michelin is certainly the leader of the French market, but its rivals are no minnows, and even in France have strong positions (also in distribution). Further, it does not seem that Michelin's policies – even though they span over a long period of years - [23] have had such strong effects on its rivals, whose collective market share – as we are told in the CFI Judgment – is increasing over the years.

Perhaps we could be more convinced of Michelin's anticompetitive strategies if it had been showed that it was selling below cost to some groups of customers (as we have seen above, discriminatory strategies might help a dominant firm to exclude by denying key buyers to the rivals) but there is no information about this point in the case.

Furthermore, we know from the literature on exclusive dealing that when there is strong competition among buyers (a fact that is emphasised by the Commission), it is *less likely*, rather than more likely as the Commission claims, that the incumbent will manage to

[22] Apart from the similarities to exclusive dealing, we should also mention that the *PRO agreement* contained some features which make it similar to tying, and that tying may be used to exclude (see e.g. Whinston, 1990).

[23] Para. 359 of the Commission Decision recites: "The infringement extended over a period of 19 years or more, since the commercial policy at issue was in operation at least from 1980 onward, and…Michelin agreed to amend its agreements with effect from 1 January 1999."

exclude an efficient firm. Indeed, Fumagalli and Motta (2006) show that if buyers compete fiercely in the downstream retailer market, each of them will have a strong incentive to deviate from the incumbent and buy from a more efficient supplier, in order to guarantee itself a competitive advantage over the other retailer-buyers (and if they steal business from the latter, they manage to (endogenously) increase the size of their orders, allowing the entrant to reach its minimum threshold size).

Finally, a natural question which arises from the reading of the proceedings is the following: if Michelin really intended to exclude rivals, why did it sell rivals' products in its *Euromaster* outlets?

Possible efficiency effects of rebates

Neither the Commission nor the Court of First Instance consider the possible pro-competitive effects that Michelin's rebate schemes may have (with the exception, as indicated above, of transaction-specific cost-savings), whereas economics does suggest that rebates may have efficiency effects.

Let us continue for convenience to divide rebates in two categories: those that 'resemble' exclusive dealing provisions and those which consist of quantity discounts. For the first category, one should recall that exclusive dealing may promote investments.[24] In particular, Segal and Whinston (2000a) and Motta and Rønde (2006) show that exclusive dealing is welfare beneficial if it helps protect investments made by the supplier which have the effect of improving the retailer's productivity in both selling the supplier's products and the other suppliers' products. In the case at hand, rebates may serve the purpose of trying to mimic exclusivity provisions (recall that exclusive dealing by a dominant firm is not allowed in the EU), and reduce the risk that an investment made by Michelin into a retailer's premises or human capital is then used by the retailer to sell products produced by Michelin's rivals. Although we do not have an explicit discussion of such efficiency effects in either the Decision or the Judgment, there are some indicia that rebates may have served the purpose of protecting Michelin's investments. Several clauses in the rebates schemes (for instance in the Service bonus and in the *Club des Amis*

[24] See Segal and Whinston (2000b) and references cited therein.

Michelin programmes) explicitly aimed at improving promotion, advertising and services provided by dealers; and in some of these schemes, Michelin committed to provide training, investments and funds. It seems logical that it does not want to invest in a dealer who sells mostly rivals' products. And in turn, by requiring a retailer to buy mostly from it, Michelin would invest more into this relationship, which would be welfare-beneficial.

As for the other category of rebates, quantity discounts, we have already seen above that they represent an instrument of price competition, and therefore – to the extent that they do not exclude rivals - are inherently beneficial to consumers.

A slightly different way to look at quantity discounts is that they can be seen as a form of two-part tariff: the more a buyer purchases, the lower the unit price paid. And we know that this is going to reduce inefficiencies: when dealers' variable cost decreases, so will final consumers' prices, causing an increase in welfare.

Furthermore, quantity discounts may indeed be justified by scale economies (even if not for any single client and transaction in isolation, as the CFI requires): the more a supplier produces and sells, the lower its production costs.

Although we do not have enough information in the published case material to quantify the importance of such efficiency effects, there seems to be enough ground to conclude that the efficiency effects of rebates should have been considered seriously.

Conclusions

The European Commission and the Community Courts de facto consider rebates by a dominant firm *per se* abusive, as *Michelin II* demonstrates. But economics teaches us that rebates may serve as a way to foster investments into the relationship between a seller and its retailers; furthermore, like any reduction in prices and to the extent that they do not exclude more efficient rivals, they have beneficial welfare effects. This should call for a completely different approach in dealing with rebates, where first the exclusionary potential of rebates is analysed, and then possible pro-competitive explanations are considered, and if appropriate weighed against the anti-competitive ones.

In this case, the Commission and the Court have made no effort in trying to formulate a coherent theory of why Michelin's rebate programmes had anti-competitive effects. Likewise, they have not considered possible efficiency effects arising from such programmes, while it is conceivable that by reducing prices in the market and by giving incentives to invest more, considerable pro-competitive effects may have arisen from them.

From the information available, instead, it does not seem particularly likely that Michelin's rebates could exclude (efficient) rivals. In fact, Michelin's market position has worsened over time despite it had used such rebate schemes. Nor can one exclude that these schemes could achieve important efficiency gains which also benefited final consumers. Had the Commission and the Court followed an economic approach, rather than a form-based one, they would have probably concluded that Michelin's commercial policy was not abusive.

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