Oxera

Agenda

Advancing economics in business

Buying loyalty: South African Airways and the ongoing saga of rebate cases

South African Airways has been fined for operating an exclusionary loyalty rebate scheme with travel agents. The latest in a series of international cases concerning such schemes, this is one of the first successful prosecutions to rely, at least in part, on showing the effects of loyalty rebates on competition

In July 2005, the South African Competition Tribunal ruled that South African Airways' (SAA) travel agent incentive schemes violated the South African Competition Act 1998.[1] The company was required to cease these incentive schemes, which reward travel agents for SAA ticket sales, and to pay a fine of R45m (€5.7m)—the largest fine imposed under South African competition law to date. Oxera assisted the prosecuting party, the South African Competition Commission, acting as an expert witness on the economics of the case.

The case focused on loyalty rebates, which offer a discount or a rebate payment to a purchaser in return for remaining loyal to a particular supplier. In this case, rebates in the form of increased commission payments were granted to travel agents in return for increasing SAA ticket sales relative to the previous year's sales. This form of rebate is a common feature of intermediate/wholesale product markets. For example, some grocery stores make a substantial proportion of their profits from rebates from goods manufacturers, and car dealerships often rely on the rebates offered to them by car manufacturers.

While there are many benign applications of loyalty rebates, those put in place by dominant firms may raise abuse of dominance concerns. Two landmark cases in this regard were the decisions by the European Commission, and subsequently by the Court of First Instance on appeal, regarding Michelin's loyalty rebates to European retailers, and British Airways' (BA) loyalty rebates to travel agents. These cases determined that, under European competition law, dominant firms should offer only cost-based loyalty rebates (eg, those offering economy-of-scale discounts), as these are considered likely to induce retailers not to deal with, or reduce their dealings with, competitors, thereby harming competition.

In addition to these cases, there has recently been a raft of loyalty rebate cases internationally (see Table 1). The SAA incentive scheme for travel agents is the latest addition to this list. This case is particularly notable as it includes at least some evidence on the *effects* caused by these agreements; most previous successful prosecutions have relied almost exclusively on the *form* of the practice (ie, offering non-cost-based incentives).

Table 1 Recent loyalty rebate cases

Case	Authority	Date of judgment	Outcome
Michelin II	European Commission and Court of First Instance	2001 and appeal in 2003	Michelin fined €19.8m; appeal upheld original decision
Scandinavian Airlines System (SAS)	Swedish competition authority	1999	Fined SKr100m (€10.7m) for frequent-flyer programme; SAS terminated loyalty rebates voluntarily
BA/Virgin	European Commission	1999 and appeal in 2003	BA fined €6.8m; appeal upheld original decision
BA/Virgin	US federal court (Second Circuit)	2001	Virgin's complaint dismissed
Alitalia	Italian competition authority	2001	Company fined €25m
Canada Pipe	Competition Tribunal, Canada	2005	Complaint dismissed
SAA	Competition Tribunal, South Africa	2005	SAA fined R45m (€5.7m)

Source: Oxera.

This article examines loyalty rebates, highlighting the current debate in competition policy about whether such loyalty rebates offered by dominant firms should be prohibited per se, or whether they should be assessed on the demonstrable effects they have on competition. Finally, the article examines the particularly strong form of loyalty rebates—override incentives—found in the Michelin, BA/Virgin and SAA cases.

Loyalty rebates: good or bad?

A loyalty rebate (also known as a fidelity discount) is, as the name suggests, a payment or a discount given by a supplier to a consumer as a reward for remaining loyal to that supplier. Loyalty rebates take many forms; however, according to analysis by the OECD, most share the characteristic that:

> the percentage discount [given to the consumer] increases, usually in discrete jumps, in response to current reference period purchase volumes exceeding purchases in a previous reference period.[2]

Loyalty rebates are unlikely to cause problems when used by non-dominant firms, since these firms are considered too small to have a significant effect on the market as a whole. However, in some circumstances, their use by dominant firms may be problematic. The landmark case in the EU concerning loyalty rebates was brought by the European Commission against Michelin in 2001,[3] and successfully upheld at appeal in 2003.[4]

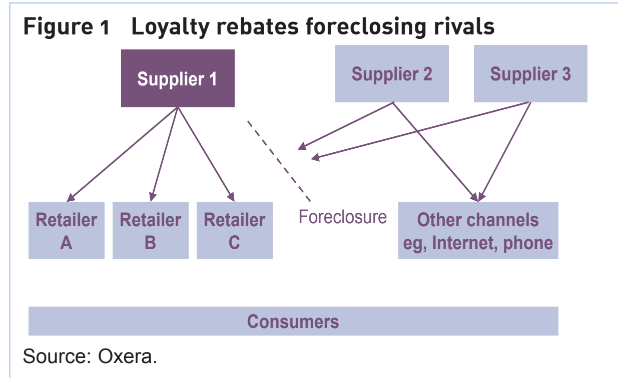
Michelin had a loyalty rebate in place with tyre dealerships. As the total quantity of Michelin products sold rose, the dealer would become eligible for a range of stepped rebates. In its 2001 decision, the European Commission concluded that the rebate had a loyalty-inducing effect, which was not cost-based, and that it was therefore an unfair barrier to competitors' entry to this market and, in turn, had the effect of foreclosing the market to competitors:

> thanks to its [high] 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 (para 241).

More generally, the Commission concluded that loyalty rebates by dominant firms are only acceptable if they 'correspond to the economies of scale achieved by the firm as a result of the additional purchases which consumers are induced to make'—ie, if they are cost-based.

Figure 1 sets out the Commission's argument more generally. In this example, Supplier 1 is dominant in the supply of goods, and has loyalty rebate agreements with the retailers. These agreements induce the retailers either not to deal, or to limit their dealings, with the two alternative suppliers, therefore substantially foreclosing these suppliers' access to the retail route to market. Whether this harms competition downstream depends on two factors:

Figure 1 Loyalty rebates foreclosing rivals



Source: Oxera.

- whether the foreclosure is substantial—ie, does it really act as a sufficient impediment to gaining access to the market via this channel?
- whether alternative routes to market, such as the Internet or direct phone sales, enable the supplier to bypass the retailer.

Following a complaint by Virgin Atlantic, the Commission also found loyalty rebates offered by BA to travel agents to have violated Article 82 of the EC Treaty. The Commission stated that:

> a dominant supplier [such as BA] can give discounts that relate to efficiencies, for example discounts for large orders that allow the supplier to produce large batches of product, but cannot give discounts or incentives to encourage loyalty, that is for avoiding purchases from a competitor of the dominant supplier.[5]

In contrast to the European judgment, the US courts did not find that BA had engaged in an abuse under US antitrust law.[6] The courts found that there was insufficient proof for a reasonable jury to conclude that the incentive schemes would result in prices above the competitive level. They stated that 'what the antitrust laws are designed to protect is competitive conduct, not individual competitors', suggesting that they considered the case brought by Virgin to be more concerned with the welfare of an individual competitor, rather than with the welfare of consumers. Interestingly, the courts found that there was a pro-competitive justification for BA's agreements:

> These kinds of agreements allow firms to reward their most loyal customers. Rewarding customer loyalty promotes competition on the merits. Since the incentive agreements serve a procompetitive purpose, Virgin must show the same purpose could be achieved without restricting competition (p. 7).

The US court ruling highlights several examples of economic theory supporting the view that loyalty rebates may not cause problems when offered by dominant firms. Chief among these are arguments relating to principal–agent theory, which suggest that loyalty rebates can serve a useful purpose of incentivising the agents (eg, retailers) of an upstream principal (eg, the supplier of goods) to sell more of its goods. For example, in a business with uncertain total demand, a retailer may be unwilling to sign up to a discount/reward scheme based on absolute volumes sold, preferring a benchmark based on the proportion of sales of the dominant supplier.

Distinguishing good from bad

The discussion above highlights the crux of the recent debate on loyalty rebates. On the one hand is the European approach, which tends to rely on form-based precedent; on the other are the US and Canadian approaches, which tend to rely more on an effects-based test of whether harm has occurred.

Recent analysis published in a UK Office of Fair Trading discussion paper suggests using three hurdles to assess whether loyalty rebates are likely to be abusive, drawing on an effects-based framework.[7]

- *Dominance*—the upstream supplier needs to be dominant in the supply of goods or services for loyalty rebates to pose problems. Without dominance, the firm would not have sufficient market power to affect the market price, and consumers would therefore not be harmed.

- *No other route to market*—even if the firm is dominant, loyalty rebates will not be problematic if competing suppliers have viable alternative routes to the market. A related test is that of whether the other routes to market are reasonable substitutes—for example, is the Internet already widely used as a sales tool for this particular type of product? Such a test might be failed for certain products (eg, clothing sales, where trying items on can often be an important part of the sales process) or in countries where Internet access is not so ubiquitous.

- *Strong incentives for retailers to act*—finally, there need to be strong incentives for the retailer to act, and remain loyal/increase its loyalty to the dominant supplier. Without such incentives, the competing suppliers can overcome the power of the loyalty rebates with their own rebate schemes. Analysis by the OECD has pointed to the degree of non-linearity in the pricing structure as being a key determinant of the strength of the incentives created.[8] Non-linear incentive agreements often take the form of override incentives, as discussed below.

To this could be added a fourth test (related to the third): that the foreclosure is substantial and thereby significantly impedes rivals' access to the distribution chain in question. If the foreclosure is not substantial, it is unlikely that any harm to competition can result. This is effectively testing whether the retailer acts on the incentive.

The SAA case: override incentives

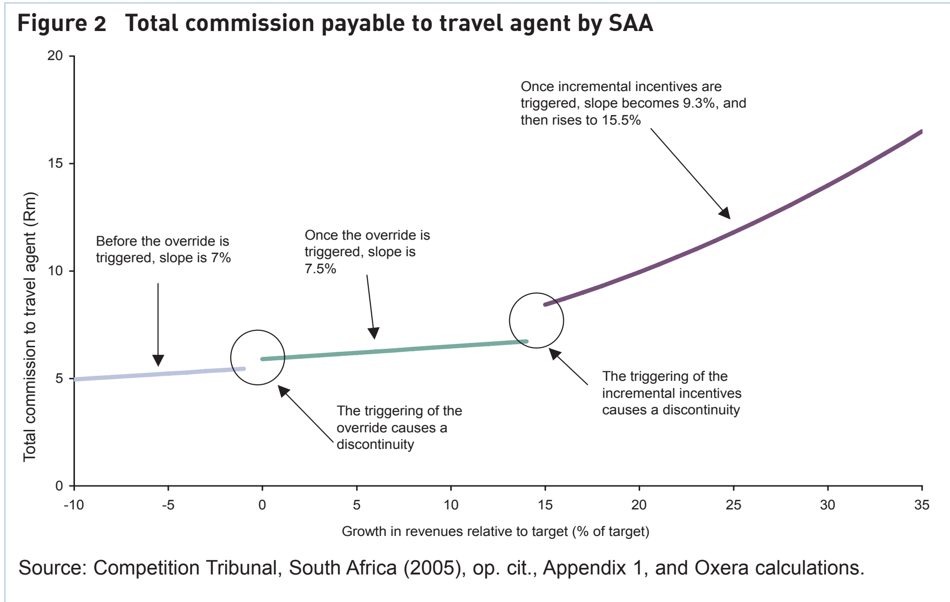
The economics of the SAA case focused on two incentive schemes offered by the airline to travel agents. The first rewarded travel agents with bonuses for growing their SAA sales relative to sales in the previous year. The second rewarded travel agency staff with air miles and other flight rewards for selling SAA tickets.

The first of these is a particularly strong form of loyalty rebate, known as an override incentive (also known as rollback incentives, or 'back to dollar one' incentives). They operate by discounting the price of (or increasing the commission on) all previous units sold once a specific target is reached. For example, were the override target equal to 100, and the base price 10, the override incentive might be to reduce the price of all units sold to 9 once 100 units are sold. The price paid by the retailer for 99 units would therefore be 99 x 10 = 990, while the price paid for 100 would be 100 x 9 = 900. By selling 100 units, the average price paid has clearly fallen substantially. As with the European cases, in the SAA case, the override incentives were applied in this way to commission rates. Therefore, as the targets were met, the commission rate on all ticket sales was increased.

The attraction of override incentives is that they provide a highly visible, high-value bonus for meeting a sales target, or buying a particular quantity. Because of the powerful incentives they generate, they potentially pose greater abuse of dominance concerns than other forms of loyalty rebate. However, these powerful incentives, if used benignly, can be the most effective means of achieving other pro-competitive benefits—eg, they allow firms to compete effectively against one another.

SAA's override incentives for travel agents increased the commission payable on all the SAA tickets sold by an agent once a specific threshold was met, creating a strong marginal incentive to meet the threshold and increase sales of SAA tickets. Figure 2 shows how the total commission paid to one particular travel agency increased as it met first its override incentive target, then its incremental incentive target. This second incentive works in much the same way as an override, but instead of making a small increase in all sales, it applies an increased commission rate to sales above the target. Incremental incentives can be thought of as payable

Figure 2 Total commission payable to travel agent by SAA



Source: Competition Tribunal, South Africa (2005), op. cit., Appendix 1, and Oxera calculations.

'back to dollar 100', similar to the way in which override incentives can be characterised as being payable 'back to dollar one'.

Figure 3 shows the incentive facing the travel agent, based on the assumption that there are just two airlines both with identical override incentive agreements: SAA with 75% market share and a 'representative' competitor with 25% market share. The line shows the total commission that the agent can earn depending on the market share achieved by SAA. The agent's commission is maximised by seeking to increase SAA's market share as far as possible. Thus the travel agent has a strong incentive to encourage travellers to choose SAA over other airlines.

Figures 2 and 3 highlight some of the evidence presented during the case to show that SAA's override agreements provided strong financial incentives to travel agents to switch sales away from SAA's competitors. In addition, the Competition Tribunal was presented with a range of evidence showing that travel agents actively responded to these incentives. Testimony from a representative of Tourvest, one of South Africa's largest travel agents, stated that:

> wherever we have the opportunity we promote our preferred supplier and that can and has been at times highly lucrative and it is on that basis that we are able to achieve our volume incentives and generate profitability in our business[9]

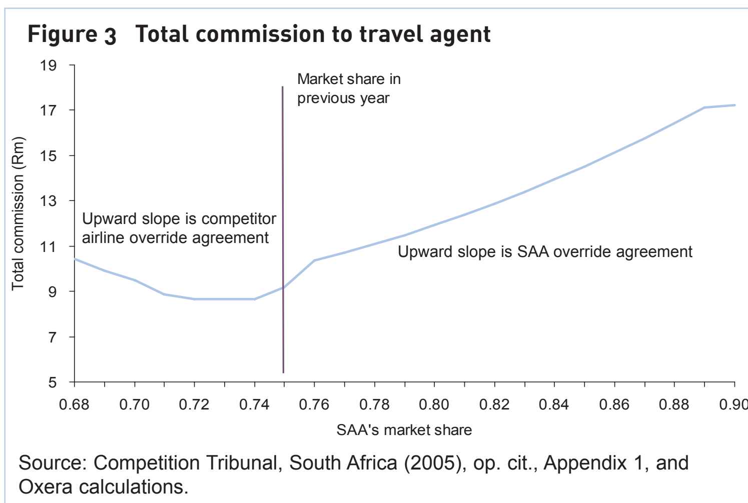
The Tribunal therefore considered that travel agents did respond to these incentives. Furthermore, because other routes to market such as the Internet were not well developed at the time, the Tribunal found that the resulting foreclosure effect was significant, concluding that:

> [the] effect of the anticompetitive conduct on the structure of the market was to inhibit rivals from expanding in the market whilst at the same time reinforcing the dominant position of SAA (p. 55).

Therefore, SAA's override incentives helped to maintain the airline's 65–69% market share. The Tribunal did not go so far as to find that there was actual harm to consumers, but stated that:

> despite the lack of evidence on this point, it is highly likely that this foreclosure has had adverse effects on consumers (p. 55).

Figure 3 Total commission to travel agent



Source: Competition Tribunal, South Africa (2005), op. cit., Appendix 1, and Oxera calculations.

Conclusion: an effects-based ruling

The SAA case is significant because it is one of the first successful prosecutions that has relied, at least in part, on showing the effects of the loyalty rebates. In contrast, the successful cases brought by the European Commission have been proven on the basis of the form of the behaviour—for example, the BA/Virgin case did not consider evidence on actual travel agents' behaviour, while the SAA case did.

Therefore, while the SAA case does not go as far as might be required in the US cases, which generally require evidence of direct harm to competition and hence consumer detriment (eg, via higher prices), the Tribunal was convinced that SAA's rebates were having some effect on consumers:

> consumers are likely to have made wrong choices of airlines, chosen the wrong prices and essentially, it has led to the wrong set of outputs (p. 55).

---

[1] Competition Tribunal, South Africa (2005), 'Reasons and Order: In the Matter between the Competition Commission (Complainant) and South African Airways (Pty) Ltd (Respondent)', Case Number: 18/CR/Mar01, July.
[2] OECD (2003), 'Loyalty and Fidelity Discounts and Rebates', February, p. 7.
[3] European Commission (2002), 'Commission Decision of 20 June 2001 Relating to a Proceeding Pursuant to Article 82 of the EC Treaty (COMP/E-2/36.041/PO—Michelin)', OJ, May, L143.
[4] Court of First Instance (2004), 'Manufacture Française des Pneumatiques Michelin vs Commission of the European Communities (Bandaq Inc., intervening)', Case T-203/01, Common Market Law Reports, April.
[5] European Commission (1999), 'Commission Decision', Virgin/British Airways IV/D-2/34.780, July, OJ, para 101.
[6] *Virgin Atlantic Airways LTD v. British Airways PLC*, 257 F.3d 256 (2d Cir. 2001). For a review of the differences and similarities between the treatment of these complaints in the USA and EU, see Niels, G. and Ten Kate, A. (2004), 'Antitrust in the US and the EU: Converging or Diverging Paths?', *The Antitrust Bulletin*, **XLIX**, 1–27.
[7] Office of Fair Trading (2005), 'Selective Price Cuts and Fidelity Rebates', OFT 804, economic discussion paper prepared by RBB Economics, July.
[8] OECD (2003), op. cit.
[9] Competition Tribunal, South Africa (2005), op. cit, p. 46.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.co.uk

Other articles in the August issue of *Agenda* include:

- **one share, one vote? golden shares in privatised companies**
- **one size fits all? cost allocation in postal services**
- **watching 3G: sector inquiries by the European Commission**

For details of how to subscribe to *Agenda*, please email agenda@oxera.co.uk, or visit our website

www.oxera.com

© Oxera, 2005. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.