

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

DAF/COMP/WD(2016)14
For Official Use

ROUNDTABLE ON FIDELITY REBATES

Note by Sweden

15 – 17 June 2016

This document reproduces a written contribution from Sweden submitted for item 6 of the 125th OECD Competition committee on 15-17 June 2016. More documents related to this discussion can be found at www.oecd.org/daf/competition/fidelity-rebates.htm

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JT03396566

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1. Introduction

1. Exclusionary unilateral conduct can seriously harm competition in both static and dynamic markets. Effective competition and innovation at the same time often require complex schemes to align incentives and enable investments. Enforcers that aim to promote effective competition must carefully examine and balance these two aspects of unilateral conduct when deciding whether an intervention in a market is to the benefit of competition or not.

2. Fidelity rebates are a type of incentive scheme that is granted to customers to reward them for a particular form of purchasing behaviour. In this note, the term fidelity rebates is used to include all conditional rebates, such as for example incremental, retroactive and exclusivity rebates. Such rebates are frequently used by both small and large firms to increase sales and thus, are part of normal business practice. They can also be used as a means of foreclosing competitors and harming competition. This submission describes the pro- and anti-competitive aspects of fidelity rebates and under what circumstances these are prioritised for enforcement by the Swedish Competition Authority (hereafter “SCA”).

3. The outcome of effective competition is often that less efficient competitors have to exit the market. In order to avoid that dominant firms extend a “price umbrella” over less efficient competitors, the SCA has applied the “As-Efficient Competitor” test (hereafter “AEC-test”) to evaluate fidelity rebates in a number of investigations. This note details the SCA’s experience in using the AEC-test in this context.

2. Non-exclusionary motives and effects

4. The main non-exclusionary motives for fidelity rebates are to enable cost savings or investments and to price discriminate between customers.

5. Economies of scale in production or distribution may induce a firm to offer fidelity rebates in order to incentivise customers to purchase volumes that allow these economies to be realised. Such economies of scale can in principle appear on either the customer level or on a more aggregate level.

6. Relationship-specific investments can also motivate a firm to offer fidelity rebates, where the rebate is used to reduce externalities, such as free-riding. In such a case, the rebate serves a function similar to that of an exclusive agreement.

7. Finally, customers are typically willing to pay different prices per unit depending on the volumes they purchase. Customers may also differ in overall willingness to pay and in quantity demanded. Fidelity rebates can then be used to differentiate between these different demands in order to allow the firm to extract as much as possible from its customers. The welfare effects from such price discrimination are ambiguous, but when rebates result in greater quantities being sold on the market, these rebates have the potential to be efficiency enhancing.

8. In order to achieve one or several of the abovementioned non-exclusionary motives as profitably as possible, a firm might prefer one form of fidelity rebate over another. For instance, depending on how a firm wishes to allocate risk between itself and its customers, the firm might have a preference for retroactive rebates over incremental rebates or for market share rebates over volume-based rebates. From a uniquely pro-competitive perspective, different forms of fidelity rebates consequently have different impact on efficiency.

9. The likelihood and relevance of these pro-competitive effects do not necessarily decrease with the firm’s market power.

3. Exclusionary motives and effects

10. Whether a particular fidelity rebate has a pro-competitive motive or not, it may nevertheless foreclose competitors from the market. In some cases, this might be the sole motive for the rebate. In contrast to the pro-competitive effects described above, significant market power is necessary for fidelity rebates to be capable of having a foreclosing effect. The main competitive harm in this respect is the foreclosure of competitors that are able to exercise effective competitive pressure.

11. In this context, it is important to recall that there is always a risk that competitors are foreclosed when a firm with market power makes any kind of attractive offer. This risk applies also to competitors that can exercise effective competitive pressure, even if to a lesser extent. The competitive harm described in this note, however, is foreclosure specifically linked to the conditionality of the rebate.

12. This foreclosure risk only arises when customers are dependent on the dominant firm for some portion of their demand (so called non-contestable demand) but not for other portions (so called contestable demand). In such a case, the price that a competitor has to match can effectively be detached from the average price of the dominant firm.

13. As opposed to predatory (unconditional) prices that involve a profit sacrifice, the sacrifice of the dominant firm offering a fidelity rebate depends on the specific circumstances of the case. For instance, when customers are fragmented and all of them opt to exclusively purchase from the dominant firm, the rebate scheme can be costless to implement. This is analogous to the case of exclusive dealing.

14. However, in contrast to exclusive dealing, the *effective price* that a competitor needs to offer to match the rebate scheme can be calculated from the scheme's design (using threshold prices and volumes, retroactive elements etc.). With retroactivity, the higher the thresholds, the lower the effective prices will be. If rebates to important customers imply that the effective prices are "too low" in the relevant volume ranges where the competitor operates, the competitor risks being foreclosed from the market.

4. The AEC-test

15. The AEC-test provides one particular cost-benchmark for conducting a price-cost test on the effective prices generated by a rebate scheme. If effective prices are below some measure of long-run average cost, this will show that a competitor, who is as-efficient as the dominant firm, cannot match the rebate without incurring a loss in the long-run.¹

16. A method for applying the AEC-test to fidelity rebates is further described in the European Commission's guidance on enforcement priorities for exclusionary conduct by dominant firms (hereafter "Commission's Guidance Paper").²

¹ For a history of the AEC-test, see Mandorff and Sahl, *The Role of the 'Equally Efficient Competitor' in the Assessment of Abuse of Dominance* (2013): <http://www.konkurrensverket.se/globalassets/english/publications-and-decisions/the-role-of-the-equally-efficient-competitor-in-the-assessment-of-abuse-of-dominance.pdf>.

² European Commission, *Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings*, OJ C 45, 24.2.2009.

5. The SCA's prioritisation for enforcement

17. The SCA's Prioritisation Policy for Enforcement³ describes the issues that are prioritised for enforcement. The main objective of the SCA is to promote effective competition for the benefit of consumers. Therefore, the most important basis for prioritisation is whether a conduct is able to harm competition and consumers.

18. As regards unilateral conduct, the SCA prioritises investigating conduct that is capable of excluding or foreclosing firms, who are able to exercise effective competitive pressure on some level of the market. In its prioritisation, the SCA gives particular consideration to the share of the market that is affected by the conduct. In assessing price-based conduct, such as rebates, the SCA also gives consideration to the outcome of the AEC-test.

6. Recent investigations of rebate schemes

6.1. *Posten AB (381/2009) – rebates on the Swedish postal market*

19. In *Posten I*⁴, a case concerning conditional rebates applied to bulk mail, Posten AB (hereafter "Posten"), the incumbent postal operator in Sweden, which offered all types of mail services ranging from single parcels to bulk mail, implemented a rebate scheme for direct advertising bulk mail under which customers received a rebate if they pre-sorted the mail according to Posten's set specifications. The per unit rebate was conditional upon the customer sending over 300,000 items per consignment and was applied retroactively to the entire volume of the consignment. The rebate scheme was subsequently extended to cover additional bulk mail services. The complainant in the case, Bring Citymail Sweden AB (hereafter "Bring Citymail"), engaged primarily in the distribution of bulk mail and reached half of the households in Sweden. Posten's services reached all households in Sweden.

20. Bring Citymail alleged that Posten's rebate scheme resulted in significant foreclosure and that the rebate scheme lacked objective justification. The SCA analysed the rebate scheme employing the approach adopted in the Commission's Guidance Paper, which recommends the use of the AEC-test. The investigation was ultimately closed due to prioritisation.^{5,6}

³ The SCA's Prioritisation Policy is available here: http://www.konkurrensverket.se/globalassets/english/aboutus/english_prioritisation_policy_for_enforcement.pdf

⁴ The decision is available here (in Swedish): <http://www.konkurrensverket.se/beslut/09-0381.pdf>

⁵ A presentation of how an AEC-test of this rebate scheme could be conducted is available here: http://www.americanbar.org/content/dam/aba/publications/antitrust_law/20120720_at12720_materials.auth_checkdam.pdf

⁶ The complainant subsequently brought a private enforcement action against Posten; the case was heard by the Market Court ("*Marknadsdomstolen*"), which held that Posten had abused its dominant position by implementing the rebate scheme in question. The Court did not require the application of the AEC-test in order to find that the rebate scheme was abusive: *Bring CityMail Sweden AB vs. Posten Meddelande AB*, MD2011:14.

6.2 *Elitfönster AB (463/2010) – rebates on the market for windows for prefabricated homes*

21. In the case of *Elitfönster AB*⁷, a leading firm on the market for the sale of windows to manufacturers of prefabricated homes, *Elitfönster*, operated a rebate scheme under which customers received a retroactive rebate based on annual purchases, if they also purchased additional products from *Elitfönster* such as skylights, exterior doors and sliding doors.

22. To evaluate the rebates, the SCA analysed whether the rebates were able to foreclose an as-efficient competitor. The SCA subsequently closed the investigation due to prioritisation.

6.3 *Posten AB II (262/2011) – rebates on the Swedish postal market*

23. In *Posten II*⁸, the SCA investigated conditional rebates applied by *Posten* to bulk mail in Sweden. *Posten*'s customers received an annual volume-based rebate that increased if the customer used *Posten*'s services for its entire needs. The SCA requested data from *Posten* concerning customers, volumes, price-setting and costs in relation to the services covered by the rebate. In applying the AEC-test in its analysis, the SCA used the price and cost- benchmarks referred to in the Commission's Guidance Paper.

24. The investigation was ultimately closed because the SCA found that the rebate scheme did not have the potential to exclude an as-efficient competitor.

6.4 *The SCA's experience in applying the AEC-test*

25. In the SCA's experience, the AEC-test can be applied at limited *administrative cost*, as the test, in general, does not require much advanced analysis. Effective prices can always be calculated mechanically from any published rebate scheme and for any volume range, whether the rebates are incremental or retroactive.

26. In applying the AEC-test in practice, the main challenge is to measure the dominant firm's costs, to which the effective price should be compared. The SCA normally uses the Long-Run Average Incremental Cost (LRAIC),⁹ which is the long-run cost incurred by the dominant firm to produce that particular product.

27. Although well-defined in theory, in general LRAIC is not readily available from the accounts of a firm. Therefore, identifying the relevant cost for comparison often requires careful considerations. However, for screening purposes, if the AEC-test shows that effective prices are far from any reasonable measure of costs, it is possible to draw conclusions regarding potential foreclosure with ease.

28. Determining the contestable share also requires careful analysis. These shares can for example be related to the geographic scope of the dominant firm and the more limited geographic scope of its competitors. However, market conditions need to be carefully analysed to ensure that the dominant firm's current scope is indicative of actual contestability.

29. The risk of foreclosure also depends on the importance to competitors of the customers that receive the fidelity rebates. A proxy for this is the share of the contestable market that the rebate scheme covers. In this context, the so called minimum efficient scale that actual or potential competitors need in

⁷ The decision is available here (in Swedish): <http://www.konkurrensverket.se/beslut/10-0463.pdf>

⁸ The decision is available here (in Swedish): <http://www.konkurrensverket.se/globalassets/aktuellt/nyheter/las-beslutet-dnr-2622011-34585kb.pdf>

⁹ See the Commission's Guidance Paper.

order to exercise competitive pressure, can also be taken into consideration when applying the AEC-test. In general, foreclosure is only profitable, and thus of a general concern, if it is capable of reducing competitive pressure. The minimum efficient scale can thus guide the volume ranges to which the price-cost test should be applied. For instance, the unit immediately above the threshold of a retroactive rebate normally entails a negative effective price; however, this single unit seldom constitutes the relevant volume range on which competitors operate and thus, is not the relevant range for the price-cost test. Instead, competitors tend to seek to compete for larger portions, or all, of the contestable market, which then constitute the relevant ranges.

30. Furthermore, it is important to recall that finding prices below cost, when applying the AEC-test, does not rule out the possibility that the rebates at the same time are enabling pro-competitive efficiencies, which then have to be included in the analysis before concluding on whether the fidelity rebates are anti-competitive or not.

31. In the experience of the SCA, the AEC-test, as an enforcement tool, contributes by being both *transparent and predictable*, in that it provides clear standards that dominant firms can relate to when developing their pricing strategies, enabling them to benchmark their rebates to their own costs, which are the only costs readily available. This limits the chilling effects that *over-enforcement* could have on competition, allowing fidelity rebates to achieve pro-competitive objectives while at the same time limiting the risks that they are used with the aim of foreclosure. Conversely, by properly taking into account the effective price that competitors have to match and thereby identifying potential foreclosure effects, the AEC-test limits the instances of *under-enforcement*.

32. In terms of eliminating these two types of enforcement risks, the AEC-test is not a cure-all however.

33. Under-enforcement can be a problem mainly in instances when competitors, who are less efficient than the dominant firm, nonetheless are capable of exercising important competitive pressure now or in the future, but who risk being foreclosed by a rebate scheme that pass the AEC-test. This enforcement error can be limited to some extent by the careful consideration of what the relevant cost measure is for a particular market, and, in cases where exclusivity is the motive and effect of a rebate scheme, evaluating the rebates as exclusive dealing.

34. Over-enforcement, on the other hand, can be limited by extending the analysis to a more detailed effects-analysis that takes into account the market coverage of the rebate scheme and examines how it impacts competitors' ability to achieve minimum efficient scale. This enforcement error is further limited by always balancing foreclosure against pro-competitive effects in the final analysis.

35. In terms of the EU legal framework, recent case law gives support for the SCA's approach of employing the AEC-test in cases involving a rebate scheme as one tool amongst others for the purposes of assessing whether there is an abuse of a dominant position in that context.¹⁰

36. To conclude, in the experience of the SCA, the AEC-test is an administrable enforcement tool that provides predictability for how dominant firms can use fidelity rebates to achieve pro-competitive ends, while preventing these firms from foreclosing efficient competitors. It also reduces the instances when these firms are encouraged to hold a price umbrella over less efficient competitors. The AEC-test allows the enforcer to analyse when potential foreclosure can arise, and, in combination with an investigation into the effects of the rebate scheme, it contributes to an enforcement policy that enables effective competition and innovation.

¹⁰ Case C-23/14 *Post Danmark A/S v Konkurrencerådet* ('*Post Danmark II*'), preliminary ruling by the Court of Justice of the European Union, 6 October 2015. See e.g. paragraph 58 and 61.