

**Unclassified****English - Or. English****18 November 2018****DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS  
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from Sweden****- Session V -****30 November 2018**

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More documentation related to this discussion can be found at: [oe.cd/csoes](http://oe.cd/csoes).

Please contact Ms. Lynn Robertson [E-mail: [Lynn.Robertson@oecd.org](mailto:Lynn.Robertson@oecd.org)], if you have any questions regarding this document.

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## *Competition Law and State-Owned Enterprises*

### **- Contribution from Sweden-**

#### **1. Introduction**

1. With SOEs operating in the same markets as private undertakings, questions arise as to how the competitive landscape is affected by their presence and conduct on the market. Some of these questions are complicated further by the non-antitrust legal framework regulating SOE conduct.
2. In 2010, rules on anti-competitive sales activities by public enterprises were incorporated into the Swedish Competition Act, and the SCA regularly receives complaints from private firms regarding SOE conduct. Complaints may concern, for instance, pricing below cost, discriminatory behaviour, refusal to grant access to infrastructure and carrying out commercial activities in combination with the exercise of public authority. A large portion of the complaints from private firms concern low prices. The SCA has therefore had reason to explore both theoretical and practical issues concerning pricing practices and costs in relation to SOEs.
3. Requirements on SOEs to price their products to correspond to certain cost measures have implications for the competitive pressure they exert on private firms operating on the same markets. The higher the costs that must be covered by the SOE's price, the bigger the room is for private undertakings to be viable on the market. At the same time, such pricing might lead to higher consumer prices and less efficient economic outcomes. Does this indicate that there is a trade-off between competitive neutrality and economic efficiency?
4. Apart from theoretical considerations, the SCA has also had to address practical issues concerning, among other things, the extraction of relevant cost measures from municipal cost accounts, which are not produced with specific consideration of questions of competitive neutrality. Some of these experiences, alongside the aforementioned theoretical considerations, are described in this contribution.
5. The legal framework

#### **2. Competitive neutrality rules**

6. In addition to the general antitrust prohibitions in the Swedish Competition Act<sup>1</sup>, which correspond to Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU), Sweden has national provisions regarding SOEs and competitive neutrality that have no foundation in the EU treaties. The Swedish competitive neutrality rules state that certain conduct by the State, county councils or municipalities, or entities controlled by them in the context of a commercial activity may be prohibited if the conduct distorts competition. A commercial activity carried out by a county council or municipality may also be prohibited in its entirety. In this contribution, the term SOE encompasses all bodies subject to the

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<sup>1</sup> Konkurrenslagen (2008:579) chapter 2 section 1 and chapter 2 section 7

Swedish rules on competitive neutrality, i.e. enterprises owned or operated by all types of public entities: municipalities, county councils and regions as well as the State.

## 2.1. The prime-cost principle

7. The Local Government Act (LGA)<sup>2</sup> is relevant in the discussion of competitive neutrality, since it to some extent regulates the prices which municipalities may charge when providing goods or services. The LGA includes a prime-cost principle (*självkostnadsprincipen*), which limits municipalities and municipal SOEs to only charging enough to cover the total costs of the municipality's goods or services offered. That means for example that municipalities are not allowed to make profits on their sales activities.

8. Measures to improve competitive neutrality may in some ways be restrained by this principle. The purpose of the principle is to prevent municipalities from excessive pricing as they often have a monopoly on their services, rather than to regulate competitive neutrality between public and private entities. The principle for instance only sets a price ceiling, not a price floor. The SOE may hence use a price only covering a minor part of the costs or give the product away free without contravening the prime-cost principle.

## 3. Cost measures used in competition law

9. The price ceiling of the prime-cost principle has similarities with the average total cost (ATC) measure sometimes used when assessing predatory pricing by a dominant company. In both cases, costs shared with other products or services are allocated *pro rata*. This could be costs for administration or some other resource shared with other products or services.

10. Another cost measure used in the assessment of predatory pricing is the long-run average incremental cost (LRAIC). In contrast with the prime-cost and ATC cost measures, only the incremental costs for the product are normally included in the calculation of LRAIC. If costs shared with other products or services do not increase as a consequence of the new product they are not incremental. Consequently, if there are shared costs which are not incremental, the cost according to LRAIC is lower than the cost according to ATC. If the company only one produces product LRAIC would be the same as ATC.

11. The European Commission discussed the relevance of cost measures to the assessment of price-based conduct in its 2009 guidance paper on exclusionary abuse of dominance.<sup>3</sup> Setting a price lower than LRAIC is, according to the Commission, considered to be able to foreclose equally efficient competitors.<sup>4</sup> The use in the analysis of a hypothetical "equally efficient competitor" implies that an effective competitive process

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<sup>2</sup> Kommunallag (1991:900)

<sup>3</sup> Commission guidance on its enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, OJ C 45, 24.2.2009, p. 7–20.

<sup>4</sup> Commission Guidance Paper, para. 26.

should be protected; not excluding competitors by other means than competing on the merits of their products or services.<sup>5</sup>

12. Other cost measures used in the assessment of predatory pricing are the average variable cost (AVC) and the average avoidable cost (AAC). Setting a price not covering AVC or AAC is considered to be a strong indication of an exclusionary strategy by a profit-maximizing firm.

#### 4. Theoretical considerations

13. The principal concern regarding low prices is a reduction in competition brought about by the foreclosure of competitors from the market. In general antitrust, the foremost issue is the foreclosure of firms that are at least as efficient as the firm responsible for the pricing conduct. In the context of competitive neutrality, however, other factors might also have to be considered.

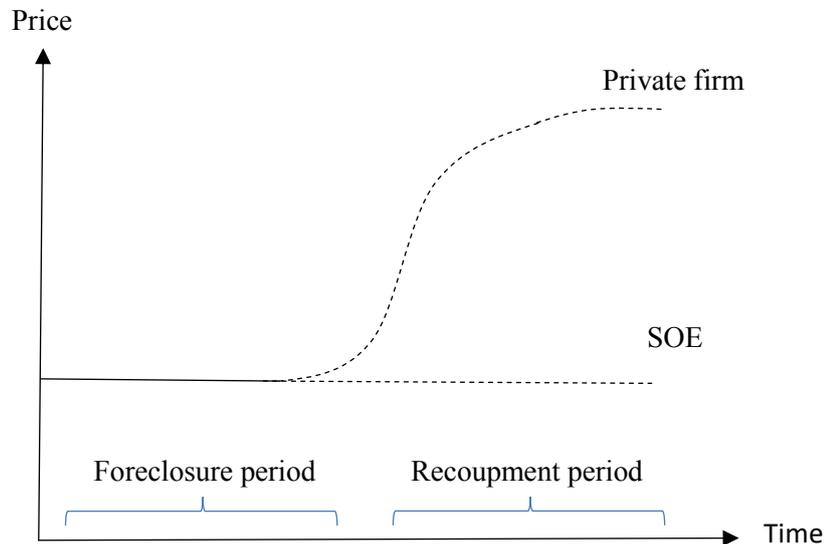
14. Whether the pricing conduct which drives out competitors is deemed anti-competitive or not, the foreclosure mechanism is the same for SOEs and private firms. By lowering the price – and thus increasing the output – the competitor's output is displaced and the competitor is marginalised or forced off the market (or is deterred from entry).

15. For private firms, the foreclosure period would normally be followed by a second period, a recoupment period, in which prices are raised and monopoly profits are extracted from the consumers. SOEs, on the other hand, would normally not be guided by a profit-maximization motive, and could well be content with maintaining the same price and output in the second period as in the first period. This would especially be the case if the SOE is output-maximizing. Given that SOEs in Sweden have to abide by the prime-cost principle (at least municipal firms), a recoupment period is even more unlikely.

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<sup>5</sup> Commission Guidance Paper, para. 6.

**Figure 1 SOEs and private firms may differ with regard to recoupment**



16. Given that recoupment might not be a factor in cases of SOEs' pricing conduct, an analysis based on an exclusionary strategy is not as relevant as in the case of private firms.

17. The absence of recoupment does not however mean that exclusion, or low prices in themselves, are harmless. Low prices and foreclosure of private firms may affect economic efficiency in a number of ways. If the most efficient producer on the market is displaced, production would not be at its lowest possible cost, thus reducing productive efficiency. If prices are set below cost, too much of a product would be produced and induce allocative inefficiency, i.e. resources would be better spent elsewhere in the economy. Finally, dynamic efficiency would be adversely affected if the pricing conduct reduced the incentives for private firms to invest in product development and innovations that would enhance social welfare in the long run.

#### 4.1. Cost measures and the competitive process

18. In cases concerning abuses of dominance, a dominant firm's prices are often compared to its costs by reference to different cost measures in order to test the economic effects and/or legality of the firm's price-based conduct. If SOEs in similar ways were required to price at least at the level of certain cost measures, how would this affect the market outcomes?

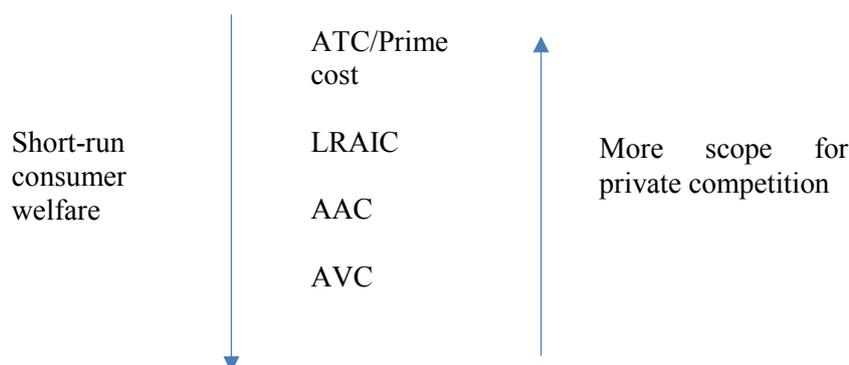
19. With an obligation to set a price at least equal to cost measures like AAC and AVC, the SOE would be allowed to price near its marginal cost of production. This might cause a rival firm, which is unable to produce at the same marginal cost, to exit the market. Furthermore, private firms that are considering entering a market where a non profit-maximizing SOE is present may not anticipate a recoupment period with higher prices, thus expecting prices to stay low long-term. This would make it unlikely that a competitor with the same marginal cost of production which has yet to incur fixed costs would decide to enter the market.

20. If SOEs are required to set prices at least at the level of LRAIC, this would require them to cover fixed costs which are incremental with the production of the product in question. But it would not require them to cover non-incremental, shared fixed costs, thereby allowing SOEs to fully pass on to the consumers any efficiencies stemming from economies of scope. Competitors which are less efficient, in so far as they are unable to realise similar economies of scope, might be foreclosed from the market. If, however, a private firm were able to achieve similar economies of scope, the private firm would be able to stay on the market.

21. Requiring an SOE to set prices at the level of ATC would offer protection for competitors that incur the same variable and fixed costs in order to be active on the market. It could however also give rise to a so-called “price umbrella”, under which competitors may reap profits and where productive efficiencies are not fully passed on to the consumers.

22. Competitive neutrality occurs, according to certain sources, when no entity operating in an economic market is subject to undue competitive advantages or disadvantages.<sup>6</sup> From a social perspective, there might be a trade-off between room for private competition on the one side and consumer welfare on the other side, at least in the short run. The size of this potential trade-off would depend on the difference between the cost measures in the specific instance.

**Figure 2 Trade-off between short-run consumer welfare and level playing field?**



#### 4.2. Is any specific cost measure always the analytically proper one?

23. The different cost measures tend to differ in the extent to which fixed costs are included or not. One can argue that the foreclosure effects of pricing at certain cost levels depend on the role of fixed costs for the product and market in question. If long-term pricing strategies are employed by the SOE (or are common practice within the field) then long-term cost measures would probably be the most relevant cost measures, since “fixed” costs are more variable in the long run. If short-term pricing can be used to deter entry or long-term investments, then this would also call for the use of long-run cost measures. The fact that recoupment periods are unlikely in the case of SOEs that are not profit-maximizing

<sup>6</sup> OECD (2012), Competitive Neutrality – Maintaining a level playing field between public and private business

points to the conclusion that fixed costs are more relevant to consider when SOEs are concerned, since entry is more easily deterred in this context.

24. The need for assessing the specificities of the products and markets when analysing the foreclosure effects of SOE conduct, and the need for correcting for cost advantages which are not reflective of true productive efficiency (see below), may call for the use of cost measures determined on a case-by-case basis, instead of deciding *ex ante* on any specific cost measure.

## 5. Which SOE cost advantages should be corrected for in order to reflect true costs?

25. Whichever of the standard cost measures is used for price-cost comparisons testing SOEs pricing conduct, one would like to correct for costs that are not truly reflective of productive efficiency. If other solutions or ways of producing goods and services are more efficient, one would expect long-term adverse effects if those were to be excluded from the market.

26. SOEs may be expected to benefit from cost advantages which are not readily available to private undertakings, based on the nature of SOEs being public entities. One of these cost advantages is the cost of capital. Public entities would normally be able to achieve a higher credit rating than private enterprises, mainly because of low risk stemming from the fact that the owner has the unique right to collect taxes and is very unlikely to go bankrupt.

27. Other cost advantages could arise based on economies of scope or scale coming from services that, for instance, the municipality is obliged to provide to its citizens and therefore might be financed by taxes.

28. An SOE might also be in a position where it can create cost advantages by adversely affecting the costs of private competitors. This would be the case if, most commonly, the municipality were in possession of infrastructure which the private undertakings need access to, or in any other cases where the municipality is exercising its public authority in ways which affect market conditions within its jurisdiction.

## 6. Difficulties in collecting cost information from SOEs

29. When investigating a case of an SOE suspected of distorting the market with low prices, a common challenge is to obtain correct information about the SOE's costs for producing the goods or services in question. Incomplete or incorrect cost information from the SOE often delays and prolongs investigations.

### 6.1. Separated accounts

30. A recurrent problem is SOEs' failure to separate in their accounts the costs of commercial and non-commercial activities. In a few sectors the separation of financial accounts is regulated by law but for most industries there is no regulation concerning separated accounts. Even where separated accounts would help SOEs to ensure that its commercial activity is not subsidized from taxes or cross-subsidization, they are often not used.

31. Another challenge in investigations of subsidized prices is to get a full picture of the costs of the commercial activity in question. Not all costs are always allocated to the activity or unit in question. In one case investigated by the SCA, costs for administrative services and buildings were absent in the income statement of the local unit.

## 6.2. Calculating incremental costs

32. It is not always evident which costs should be classified as incremental. Administrative services like accounting, HR, IT services etc. may be organized within the unit of the commercial activity but may equally be supplied by another unit or a parent company, or come from more centrally organized staff within the municipality, depending on the operating mode.

33. When estimating incremental costs it may be difficult to appreciate to which extent these costs depend on the commercial activity in question and the extent to which incremental production of the product in question implies decisions to increase, for instance, administrative staff.

## 6.3. Produced quantity

34. There are not only difficulties in finding the right cost information. In some cases it is also not evident what quantity the SOE has produced. Information about externally sold units might not be compiled and thus might not be easily accessible. The information about the volume of the products supplied internally within the SOE is often even vaguer, especially if the SOE has no system for internal payments.

35. In such cases it may be difficult to estimate the quantity of both the commercial and the non-commercial activity. These difficulties may complicate cost allocation and calculation of unit costs.

## 6.4. Production costs and revenues considerably different compared to private actors

36. In some cases, the public actor has a structure of costs and revenues dramatically different from private actors. This could, for example, be the case when the public actor has a sales activity with the purpose of employing disabled persons. This kind of activity can be subsidized, but also has higher costs than private actors. If this is the case, the SCA may benchmark the risk for distortion of competition against prices on the market.

## 7. SOEs using existing facilities and resources in providing sales externally

37. Often the commercial activities of an SOE are closely integrated with non-commercial activities. The commercial activity could consist of external sales of a service or product also provided for internal use by the SOE. An example is a school restaurant which, besides serving lunches to its students, also sells lunches to the external market. Another example is a municipality producing soil and gravel for internal use while also selling the products externally. In many of these cases, the majority of the costs would probably be identical for the commercial and non-commercial activities. Depending on if the internal and external sales would be considered as two different products or as one product, the outcome of the calculation of the LRAIC may differ quite a lot. In some cases

the outcome of the calculation would be more similar to the outcome of AVC and AAC than ATC. When it comes to calculating the incremental costs the extra volume produced for external sales might only lead to a smaller part of incremental costs, even in the long run, whilst grouping the external and internal sales as one would give a quite different result in the calculation of LRAIC.<sup>7</sup> In the latter case, the LRAIC would however not reflect the incremental costs of the commercial sales activity alone.

## 8. Case study: Outcome of a calculation of incremental cost

### 8.1. A school providing conferences to the external market

38. The SCA investigated allegations of below-cost pricing by a school that, besides providing students an education, also used the facilities to provide lunches and conferences to the private market. The school is situated in a scarcely populated area with limited business opportunities. A few smaller, local companies operating in the area complained to the SCA about what they saw was unfair competition from the school. The investigation of the SCA showed that the school had a major share of the local market for day conferences. It also showed that the school did not make any price calculations and that the costs exceeded the prices for some services. The investigation was closed following some changes in pricing. There were also actions taken by the school to improve the financial control of the unit.

### 8.2. Calculating costs for food services

39. The school provided food services such as lunch and coffee as part of a joint conference service also including the rent of meeting facilities. Food services were produced and served on the facilities of the school restaurant at the same time as the lunches or coffee being served to the students and teachers.

40. The external sales did not normally lead to any additional costs for kitchen staff or local costs. The planning was done by staff involved in planning school activities. There might, however, be some minor additional administrative or other costs. The only major incremental cost was the cost of food. A price only covering the incremental costs would, in this example, cover around half of the ATC, see *Commercial activity – lunches* in figure 3. Calculating the external sale as one product separated from the internal sale, the LRAIC would be similar to AVC and AAC as all the investments necessary for providing the food services were made for providing food services internally. This would also be the case in the long run.

41. Instead of calculating the incremental costs for the extra volume coming from the external lunches, the calculation could be based on the incremental costs for the complete function of the kitchen with external and internal sales. In this case, besides food, costs for kitchen staff, kitchenware and other costs of the kitchen could also be seen as incremental,

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<sup>7</sup> Given that the sales to the external market would result in very small incremental costs but the price would be higher, for example based on the average prime cost of the internal and external sales, the external sales would give the SOE extra resources. These resources could be spent in a variety of different ways either in the production of the same activity or other activities. This could hence lead to incremental costs because of a looser budget than necessary for the production of the products or services provided.

including the cost of the kitchen and restaurant premises. In this case, more than 90 per cent of the costs of the lunches would be considered to be incremental. Additionally, a larger part of the administration and other costs might be considered to be incremental, see *Commercial and non-commercial activity – lunches in figure 3*.

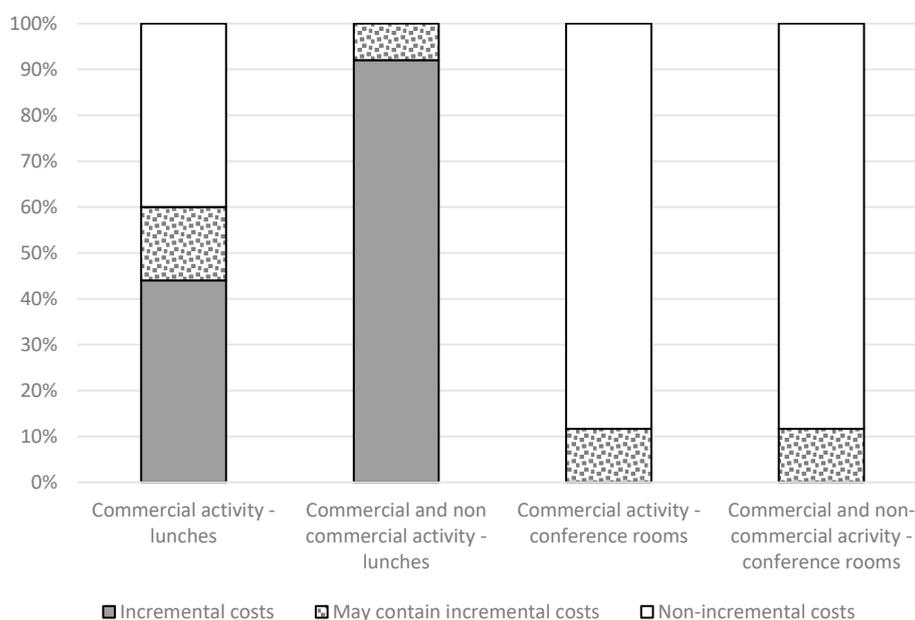
### 8.3. Calculating costs for meeting rooms

42. The meeting rooms used for external conferences were normally used for education and internal meetings of the school, and occasionally they were used for internal conferences sold within the organization of the SOE.

43. Since the premises were normally used for educational purposes or administration of the school, the external sales did not lead to any incremental costs for the building like heating, maintenance, interest or depreciation. The cleaning and janitorial services as well as administration of booking and invoicing were normally covered by existing resources. The external sale of conferences therefore normally did not lead to any or only very insignificant incremental costs for the school.

44. Besides providing external customers with meeting rooms as part of a conference there were also occasionally internal conferences sold to other units within the SOE. Including these internal conferences in the calculation of LRAIC does not change the outcome as it does for the food services since the costs did not arise from the internal conferences but from the school activities, see figure *Commercial and non-commercial activity – conference rooms* in figure 3.

**Figure 3 Distribution of incremental and non-incremental costs**



Source: The example comes from a case investigated by the SCA.

#### 8.4. Conclusions concerning the calculation of incremental costs

45. In the case described above, only calculating the incremental costs for the external sales would reflect only a smaller part of the ATC for lunches and an insignificant part of the ATC for conference rooms. Calculating a common LRAIC for internal and external sales would include over 90 per cent of the costs included in the ATC for lunches. Concerning the cost of meeting rooms, the incremental costs of conference activities would still represent an insignificant share of the ATC since the costs arose from education and not from providing conferences. Additionally, the calculated LRAIC could be very close to the cost measures AVC and AAC. This example shows that the choice of cost estimation method in some cases is decisive for the finding of an infringement or not. It also indicates that, seen from a competitive neutrality perspective, prices set strictly according to an SOE's incremental costs could give very different conditions on the market in comparison with private actors without the advantages of the SOE.

### 9. Conclusions

46. Low prices set by SOEs leading to foreclosure of private firms might not be followed by a recoupment period consisting of higher consumer prices. Foreclosure may nevertheless lead to economically inefficient outcomes, e.g. if the more efficient producer of a product is displaced, or if socially beneficial innovation is discouraged. Requiring pricing with reference to the cost measures usually employed in abuse of dominance cases affects the competitive landscape differently depending on the specificities of the product and market in question. This may call for case-by-case decisions on which cost measure to use in a price-cost comparison by competition authorities. Any cost measure used may need to be adjusted in order to reflect the true cost for producing a certain product.

47. Furthermore, there are several practical challenges in investigations concerning below-cost pricing by public entities. Often the SOE's commercial activity is not economically separated from its non-commercial activities. The allocation of costs may also be inadequate, thus giving an incomplete picture of the costs of the commercial activity in question.

48. The commercial activity could consist of the external sale of goods or services also produced for internal use by the SOE. The incremental costs of producing the extra volume for external sale might be low, even in the long run. Seen from a competitive neutrality perspective, therefore, an SOE setting prices strictly according to its incremental costs could find itself in a very different competitive situation on the market in comparison with private actors, which may not have the same advantages as the SOE.