Unclassified **DAF/COMP/WD(2016)2**

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development **23-May-2016**

English - Or. English

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP/WD(2016)2
Unclassified

ROUNDTABLE ON FIDELITY REBATES

- Note by Brazil -

15 - 17 June 2016

This document reproduces a written contribution from Brazil submitted for Item 6 of the 125th OECD Competition committee on 15-17 June 2016.

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JT03396450

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FIDELITY REBATES[1]

1. Introduction

1. This contribution introduces CADE's approach to single-product loyalty discounts. Fidelity or loyalty rebates may be defined as a discounting practice that benefits buyers that purchase the totality or a significant amount of a certain good from a given producer. Although it is widely recognized that fidelity rebates schemes are common and, in most of the times, have positive effects, in some cases they can be anti-competitive.

2. In light of that, those schemes may come under antitrust scrutiny as vertical restraints – restrictions imposed by a dominant supplier over its customers, restricting those customers' ability to buy from the dominant supplier's competitors. Vertical practices might be considered illegal if they create mechanisms to exclude rivals either by increasing barriers to entry or by increasing the costs of competitors, or when they create conditions for coordination between producers, suppliers or distributors.

3. The next section (2) will address the legal and analytical framework under which the Brazilian competition authority analyses such practices. Section 3 summarizes the cases examined in the last years. Section 4 and 5 describe in deeper detail the most recent cases judged by the authority, whereas Section 6 presents a brief conclusion.

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2. Legal and analytical framework

4. In Brazil, the analysis of anti-competitive conduct requires careful examination of its concrete and potential effects in light of article 36 of Law 12.529/2011, the Brazilian Competition Act.

5. According to article 36, "*the acts which under any circumstance have as an objective or may have the following effects shall be considered violations to the economic order, regardless of fault, even if not achieved: (i) to limit, restrain or in any way injure free competition or free initiative; (ii) to control the relevant market of goods or services; (iii) to arbitrarily increase profits; and (iv) to exercise a dominant position abusively*".[2] In the same article, the law provides a list of examples[3] of conducts that shall characterize violations to the extent that they fall within the provisions stated in the transcribed caput and items. Among those examples, there are both horizontal practices (such as agreements between competitors to manipulate prices, divide markets, and others) and vertical restraints (such as retail price maintenance, exclusive dealing, certain discount practices, refusal to deal, tying, price discrimination, and others). If a practice is considered illegal, the authority may impose fines of one tenth percent (0,1%) to twenty percent (20%) of the gross sales of the company in the field of the business activity in which the violation occurred, which will never be less than the advantage obtained, when possible the estimation thereof.

2 According to the law, "*Achieving dominance in a market by natural process and by being the most efficient economic agent in relation to competitors does not characterize the tort set forth in item II of the caput of this article.*"

3 The list of examples of possible violations set by the law is: "*I – to agree, join, manipulate or adjust with competitors, in any way: a) the prices of goods or services individually offered; b) the production or sale of a restricted or limited amount of goods or the provision of a limited or restricted number, volume or frequency of services; c) the division of parts or segments of a potential or current market of goods or services by means of, among others, the distribution of customers, suppliers, regions or time periods; d) prices, conditions, privileges or refusal to participate in public bidding; II - to promote, obtain or influence the adoption of uniform or agreed business practices among competitors; III - to limit or prevent the access of new companies to the market; IV – to create difficulties for the establishment, operation or development of a competitor company or supplier, acquirer or financier of goods or services; V – to prevent the access of competitors to sources of input, raw material, equipment or technology, and distribution channels; VI - to require or grant exclusivity for the dissemination of advertisement in mass media; VII – to use deceitful means to cause oscillation of prices for third parties; VIII - to regulate markets of goods or services by establishing agreements to limit or control the research and technological development, the production of goods or services, or to impair investments for the production of goods or services or their distribution; IX - to impose on the trade of goods or services to distributors, retailers and representatives, any resale prices, discounts, payment terms, minimum or maximum quantities, profit margin or any other market conditions related to their business with third parties; X - to discriminate against purchasers or suppliers of goods or services by establishing price differentials or other operating conditions for the sale or provision of services; XI – to refuse the sale of goods or provision of services for payment terms within normal business practice and custom; XII – to hinder or disrupt the continuity or development of business relationships of undetermined term, because the other party refuses to abide by unjustifiable or anticompetitive terms and conditions; XIII - to destroy, render useless or monopolize the raw materials, intermediate or finished products, as well as to destroy, disable or impair the operation of equipment to produce, distribute or transport them; XIV - to monopolize or prevent the exploitation of industrial or intellectual property rights or technology; XV - to sell goods or services unreasonably below the cost price; XVI – to retain goods for production or consumption, except to ensure recovery of production costs; XVII - to partially or totally cease the activities of the company without proven just cause; XVIII - to condition the sale of goods on the acquisition or use of another good or service, or to condition the provision of a service on the acquisition or use of another good or service; and XIX - to abusively exercise or exploit intellectual or industrial property rights, technology or trademark*."

6. A general framework for the analysis of restrictive practices was given by CADE's Resolution 20, from 1999. The main text of the Resolution was revoked in 2007, but its annexes are still valid. Although the provisions contained in Resolution 20' annexes are very broad, with no specific procedures for the analysis of fidelity rebates, they state basic guidelines that have been consistently followed in CADE's case law.

7. Annex I of Resolution 20 defines the main categories of restrictive practices and, in the specific case of vertical restraints, the document stresses the relevance of an effects-based approach. Annex II stablishes some basic criteria and the three steps that should be followed in the analysis, namely: the description of the conduct; relevant market definition and market power assessment; and competitive analysis of the conduct itself.

8. Besides the general provisions contained in Resolution 20, it is quite well stablished in CADE's case law that vertical restraints shall be evaluated under an effects-based approach rather than a *per se* rule of illegality. Thus, it is crucial to demonstrate the existence of market power (usually, but not only, measured in terms of market share) and the practice's ability to generate a substantial impact in the market, representing a relevant risk to competition.[4] Besides, the agency should consider not only the possible anti-competitive effects, but also the possible economic efficiencies resulting from the practice, in order to verify its net impacts on competition and consumers.

3. Case law

9. CADE's experience with fidelity rebates is limited to a few cases in the last years. The first cases were decided by the authority in the year 2000[5]. The companies O Estado de São Paulo and Folha de São Paulo – the two main newspapers in the state of São Paulo – were accused of anticompetitive behavior, which consisted in the offer of significant bonuses for clients who concentrated their advertising in one single vehicle, creating a *de facto* exclusivity that may have the effect of excluding rivals. CADE concluded that the practice was illegal.

10. Some years later, CADE received a complaint against Microsoft Informática Ltda. According to Paiva Piovesan Engenharia & Informática Ltda[6] – a competitor in the market of financial software which produced a software called Finance –, Microsoft (which produced the software Money) was adopting a series of anticompetitive conducts aiming to exclude rivals. Among those conducts, Paiva Piovesan mentioned that Microsoft was granting discounts to software distributors proportional to the sold volume. According to Paiva Piovesan, this incentives scheme would have the effects of excluding rivals, since the benefited distributors would privilege Microsoft's product over other competitor's similar software. CADE however concluded that Microsoft's conduct was not capable of having foreclosure effects, since there was still a considerable number of distributors available in the market.

11. One of the most important CADE's decisions concerning fidelity rebates is the Ambev case[7], which will be described in detail in the next section.

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4 According to art. 36, §2, "*A dominant position is assumed when a company or group of companies is able to unilaterally or jointly change market conditions or when it controls 20% (twenty percent) or more of the relevant market, provided that such percentage may be modified by Cade for specific sectors of the economy*."

5 Administrative Proceedings 08000.000128/1995-98 and 08000.161153/1995-89.

6 Administrative Proceeding 08012.001182/1998-31.

7 Administrative Proceeding 08012.003805/2004-10.

12. In the Ambev case, CADE carried out a much deeper and sophisticated analysis than it had done in previous cases. In this decision, the competition authority stated that discount programs may be considered pro-competitive if they (i) approximate prices to producer`s marginal costs or (ii) increase buyers` bargaining power, once they give incentives to concentrate purchases in one supplier. In those cases, there is an increment of both allocative efficiency (reducing deadweight loss) and technical efficiency (economies in production or distribution). In certain circumstances, notably when an entrant carries out such practice, there are also positive effects in terms of dynamic efficiency, once the discounts may be a way to induce consumers to try new products – and consequently enhance competition. Considering all these reasons, fidelity discount programs are considered, *a priori*, very positive.

13. On the other hand, Ambev’s case decision considered that the possibility of anti-competitive effects depends on if and to what extent such discounts reduce transparency or constitute a veiled mechanism to monopolization. In other words, the conduct would be anti-competitive if it excludes or restricts (even potentially) the operation of equally efficient firms, reducing social welfare. This potential exclusionary effect can only be examined on a case-by-case basis and in consideration of the market in which the discounting practice takes place.

14. It is possible to conclude that in all of the mentioned cases the main concern was the possibility of market foreclosure derived from conditional discounting programs that could have effects similar to exclusive dealing agreements.

15. It is worthy to mention that vertical restraints can also be examined in merger control, since CADE should examine contracts that contain vertical restrictive clauses if the firms involved meet the revenue threshold set by the Law. Several licensing agreements between Monsanto Brazil Ltda. and other companies, which will also be described in more detail in the following sections, illustrate CADE’s throughout analysis of contracts between vertically related parties notified to the agency.

4. The Ambev case[8]

16. The case involved a fidelity program called “Tô Contigo” implemented by American Beverage Company – Ambev, the leading Brazilian brewery company, which had 70% of market share in the country. According to the loyalty program`s rules, Ambev would reward point of sales (POS) for the selling of the company`s products: for a certain quantity of beers sold, the POS accumulated points that could be exchanged for attractive prizes, equivalent to discounts.

17. The company had considerable market power, since it was the absolute leader in all geographic relevant markets. Ambev owned the best-perceived brands, had the highest unity price and the greatest degree of fidelity from consumers. Besides, the brewery market has important barriers to entry, which consists specially from brands and access to distribution channels.

18. Ambev claimed that the program had no anticompetitive effects. The formal rules of the program were transparent; there were no exclusivity provisions, no restriction to the selling of other brands, and no minimum quantities required for a POS to participate. Moreover, Ambev argued that there were no disadvantages, in terms of prices, deadlines to deliver the products or discounts, between participants and non-participants POS.

19. However, after a deep investigation, which included an inspection at the company`s headquarters, the authorities found out strong evidence that this was not a simple fidelity program via bonus awards.

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8 Administrative Proceeding 08012.003805/2004-10.

Instead, internal documents demonstrated that Ambev had the intention to limit competition through the creation of artificial barriers to the entry of other competitors.

20. First, there was a set of informal rules that substantially differed from the formal ones Ambev declared. For example, while the company claimed that the program did not require exclusivity from the POS, there was evidence that exclusivity, or the acquisition of a minimum share of 90% of Ambev`s products, was required from selected POS. Besides, there was also evidence that Ambev`s strategy included retaliation in cases which the POS sold other brands.

21. The prizes were not the only incentives given to POS: other advantages such as price discount, and discounts in one specific brewery brand (Antarctica), were also used as tools to negotiate the participation of POS in the program. CADE`s decision explicitly mentions that those incentives would be considered pro-competitive if the program did not impose, in return, limitations to the acquisition of products from Ambev`s rivals. It is also important to note that, on the contrary to what Ambev alleged, the discounts were not uniform: the program privileged strategically chosen POS, according to unclear criteria.

22. Besides the analysis of the several inconsistencies between formal rules and the implementation of the program in practice, CADE`s decision also focused on the economics effects of the conduct. The authority concluded that the program had the effect of changing the pattern of competition in the market: instead of competing in the margins, rivals begin to compete for the POS. However, even equally or more efficient rivals would not be able to compete in this new pattern, once Ambev`s brand portfolio was so strong that demand for those products was rigid. In other words, Ambev`s market power was such that it was not possible, to a POS, to stop selling Ambev`s brands to privilege other competitors' brands.

23. In this context, the program works as an incentive for POS to concentrate all their demand in Ambev`s produtcs. This increases rivals costs, once they have to increase marketing spendings and to grant higher discounts than the dominant firm. Those costs are also incremented since the entrant has to compensate the POS for penalties imposed by Ambev for those POS who leave the program.

24. Those effects were strengthened because the discounts were non-linear (the unitary price paid out by the buyer decreasds with the number of units acquired). The non-linearity, with a firm that detains 70% of the market, makes it necessary for rivals to grant discounts by far superior than those granted by the dominant firm, causing an imbalance in the market and leaving in disadvantage even equally efficient competitors. According to CADE's decision, if, for example, Ambev gave a small discount of 3% to loyal POS, competitors would have to grant at least a 7% discount to be able to compete – which might be sufficient to keep those competitors away from the market.

25. An important Ambev claim is that the program did not reach an expressive quantity of POS. However, CADE did not consider this argument sufficient to put away competition concerns: even if the program reached around 20% of the volume commercialized by Ambev, it was focused on strategically chosen POS. It is important to note that the company had other formal exclusivity agreements with POS outside the scope of Tô Contigo; to estimate the correct dimension of foreclosure effect, it would be necessary to consider both formal exclusive agreements and the exclusivity granted by informal rules of Tô Contigo.

26. Ambev was not able to demonstrate that the practice had economic efficiencies capable to compensate all those potential anti-competitive effects.

27. In short, considering (i) the considerable market power held by the company; (ii) that even though the formal rules of the program did not mention any exclusivity requirements, those requirements had occurred in practice at least for a group of selected POS; (iii) that the non-linearity if the discounts

granted imposed an additional difficulty for Amveb's rivals; (iv) that the company was not able to demonstrate compensating efficiencies and (v) the bad faith evidenced by internal documents demonstrated anticompetitive intent and also strategies to hide the company practices from the competition authorities, Ambev was condemned in the 2009 to pay a fine of 2% of its revenues in Brazil, totalizing R$ 352,7 million – the highest fine imposed by CADE to a single company until that moment.

5. Monsanto cases[9]

28. Other interesting cases are the licensing contracts through which Monsanto Brazil Ltda. authorizes other companies to develop, produce and commercialize, in Brazil, soy seeds with Intacta RR2 PRO technology. CADE examined these cases in the context of merger control.

29. Monsanto was the leader in the market. Considering its subsidiary Monsoy, that at the time controlled about 23% of the market, and Monsanto's licensees, the company had the ability to influence about more than 80% of all the Brazilian soy seeds productive capacity.

30. According to CADE, some contracts clauses gave Monsanto the ability to influence strategic decision of the licensees. This possible influence would go beyond the limits of those contracts, reaching not only Intacta seeds, but also all the production of the licensees, due to the incentives systems designed in those contracts.

31. The contracts stablished an incentives scheme through which part of the royalties received by Monsanto from farmers should be payed to breeders (licensees). The amount received by those breeders would depend on their portfolio mix: the higher the percentage of RR2 seeds compared to other seeds, the higher the payments received by the breeder would be. On the other hand, if the licensee decided to expand the production of other seeds (without using the Intacta technology), the payment obtained for what had been produced with Intacta technology would be lower. Thus, the effects of these contractual provisions were equivalent to those of fidelity rebates. Competition would be economically viable only if Monsanto's rivals compensated this reduction in licensees' profits.

32. CADE considered that this incentives scheme had the potential to reduce the interest of Intacta seeds breeders and multipliers to develop or produce competing technologies, raising barriers to entry in the transgenic soy market – even in the absence of explicit exclusivity provisions. The decision also considered that the alleged economic efficiencies were not sufficient to compensate those potential negative effects. The mergers were approved under the condition that those contract clauses were modified.

6. Conclusions

33. Although there are no specific guidelines to analyze fidelity rebates cases, CADE's case law has been consistent in applying an effects-based approach. It recognizes that conditional discounting schemes can have benefits and efficiencies but, under some circumstances, they can also raise competitive concerns.

34. The line between one situation and another, however, is not easy to be drawn and CADE adopts a case-by-case approach. The potential exclusionary effect of a certain practice can only be evaluated through the exam of the concrete case and market in which the discounting practice takes place. In this exam, both potential anti-competitive effects and the alleged compensating efficiencies must be taken into account.

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9 Merger proceedings 08012.002870/2012-38 (Monsanto and Syngenta), 08012.006706/2012-08 (Monsanto and Nidera), 08700/003898/2012-34 (Monsanto and Coodetec), 08700.003937/2012-01 (Monsanto and Don Mario) and 08700.004957/2013-72 (Monsanto and Bayer).

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