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ROUNDTABLE ON FIDELITY REBATES

Note by Chile

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This document reproduces a written contribution from Chile 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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FIDELITY REBATES
CASE 165-08 FNE AND CC VS. CCF

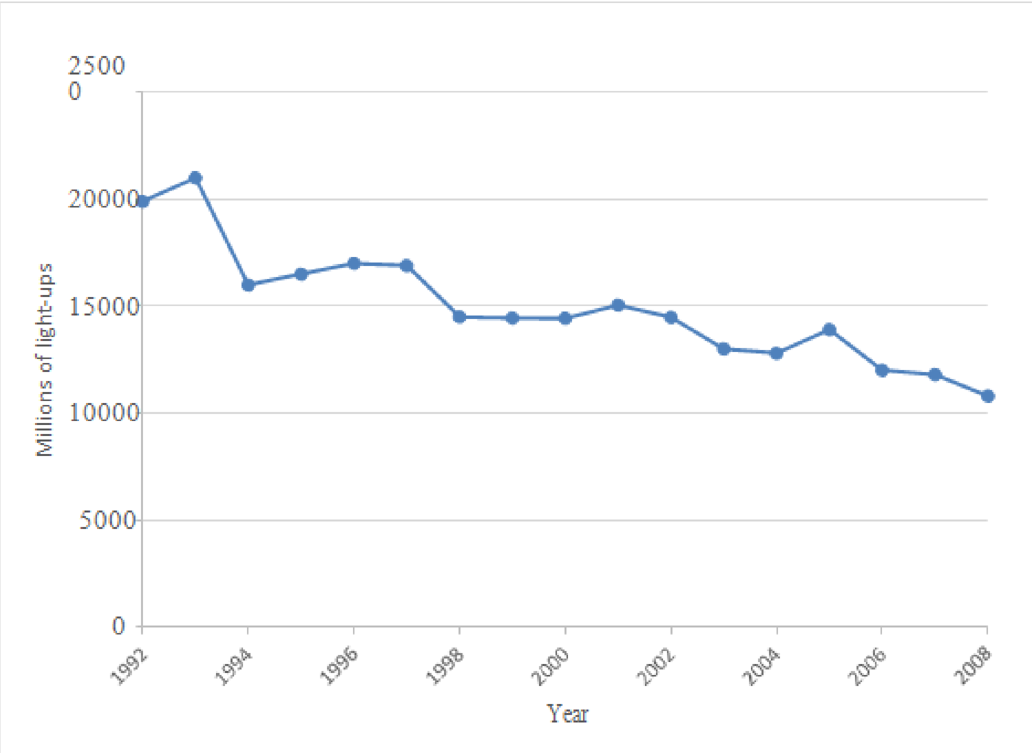
1. Brief description of the chemical matches industry in Chile in 2008

1. In 2008 the chemical matches industry in Chile was dominated by one company, the “Compañía Chilena de Fósforos” (Chilean Matches Company, or “CCF” onwards) which produced the matches (being the only company that made them in Chile) and sold them to retailers, accounting historically for more than 80% of all chemical matches sold in the country, and more than 90% in 2006. All other brands sold in Chile were imported from abroad, mainly by Canada Chemicals, and distributed to consumers through small and medium-sized supermarket chains.

2. Even though the sunk costs of producing chemical matches from scratch made it very difficult to enter the market this way, there was still the possibility to enter the market by importing matches from neighboring countries. In this respect, no legal or economic barriers to entry were found in the importing of chemical matches, but the costs of insurance and freight were found to be relevant enough to prevent, or at least discourage the entrance of new competitors through importing.

3. In this particular period, the chemical matches market was shrinking, with a sales trend that was almost monotonically lower than the previous years, mainly because of the increase in sales of pocket lighters and new technologies like self-lighting stoves, water heaters and electric lighters. The following graph shows the development of sales in this market (measured by the number of light-ups provided) between 1992 and 2008.

Figure 1. Evolution of sales between 1992 and 2008



Source: TDLC Sentence N° 90/2009

2. . Types of rebates or discounts used

4. CCF established exclusivity discounts and fidelity rebates exclusively tailored for each distributor or retailer.

2.1 Exclusivity discounts

5. Discounts were made to retailers that sold exclusively CCF's products. These discounts were around 6% of the total bought each month. These discounts effectively closed the market for new entrants, as can be read on the e-mails from the retailers to CC. Those communications stated, in general terms, that they couldn't distribute their products because of an exclusivity agreement with CCF.

6. No measure of the degree in which these contracts affected the competition in the market was made by the prosecutor or the tribunal, concluding that the dominant position of CCF in the market and the signing of exclusivity agreements with retailers or distributors was enough to affect the market. There was no measure if the 6% discount offered was an incentive (or, if not achieved, a punishment) of enough importance to effectively close the market.

2.2 Fidelity rebates (sales goals rebates)

7. After the elimination of most of their exclusivity agreements, CCF started to offer discounts for achieving certain sales goals (also known in the economic literature as fidelity discounts). The discounts offered were indivisible -the company either got it or didn't, depending on the goal set- and in many cases considered as goal the sales of a previous month in which there was an exclusivity deal active, thus perpetuating the deal.

8. The competition authority in Chile established that fidelity discounts were sometimes efficient, producing some positive effects (like lower prices and incentives for distributors), but could also produce anticompetitive effects, therefore requiring further case-by-case study.

9. In this particular case, the fact that: (i) CCF had a dominant position in the market; (ii) there was little fringe competition because of the high costs of importing and the impossibility of producing internally (at least in the medium term); and (iii) the total demand of matches was shrinking notoriously in the last few years; were enough for the tribunal to deem these discounts as anticompetitive, and the reasoning was as follows.

10. When distributors sign a fidelity discount that considers as a goal the sales of previous periods in which demand was higher than in the present day, there is a clear incentive to buy all their products from one and only one source, trying to achieve these goals as well as they can. In this sense, the distributor doesn't really have a choice of buying from a second producer or importer, closing the market for their entry (or eventually forcing them out). More so, if –as we have explained previously- these goals were pegged to the sales achieved in a period in which the distributor was under an exclusivity deal with CCF, the effect of a shrinking demand was amplified, further reducing the incentives to contract with another supplier.

11. In this case, after analyzing all the contracts signed, the Tribunal established that the discounts offered were tailor made –considering past and expected future sales- for each distributor, with the sole purpose of excluding rivals.

3. Defenses by CCF

12. First and foremost, CCF argued that the market definition was too restrictive, and should also have considered pocket lighters and other kinds of matches (in particular, non-safety matches, which light up in any surface), defining it as the “light-up” market. This line of defense was discarded by the Tribunal, based on the economic evidence brought into court regarding the use of chemical matches, which showed that, for many consumers, pocket lighters and other “light-up” accessories were not a substitute for matches.

13. Regarding the possibility of executing predatory or abusive practices, the company said that importing this product didn’t require significant investments and that at any moment a new competitor could have entered the market, more so if CCF had tried to increase prices or abuse of their dominant position.

14. Concerning the discounts challenged by FNE and CC, CCF argued that those discounts were not widespread among retailers, that the exclusivity contracts represented just a small proportion of total sales, and that the discounts were the result of bilateral negotiations between the company and each distributor, and thus had a competitive and operational logic that is consistent with competition. The fact that the main supermarket chains (which account for more than 60% of sales in the supermarket segment) sold other brands of chemical matches proved, in their opinion, that they weren’t restricting the entry of new competitors.

15. Another defense for signing exclusivity clauses was that in small or medium sized supermarkets the matches are generally assigned a very reduced space in the aisles, because of their reduced margins. Such small space allows for only one brand of matches to be sold, because otherwise the management would be too cumbersome for the seller, and generally they went for the biggest and better known brand (which in this case turned out to be that of CCF).

16. Furthermore, the defense argued that all exclusivity contracts had a span of no more than one year, thus allowing for other competitors to sell through that distributor in no more than 12 months, if the distributor wanted so.

17. Finally on the subject of incentives for growth or number of units sold, the defendant argued that those were the result of the irruption of new technologies -many of which were subsidized in their production-, and that they never had the intention or the effect of excluding an importer from the market. Instead, those incentives were established to try and attenuate the fall in units sold seen in previous years.

4. Which standard to use

18. In the final decision of this case there was no explicit discussion about the standard of efficiency that a competitor must accomplish to be considered an efficient entrant, or an entrant whose entry would increase competition or lead to a higher social welfare.

19. From this (lack of) analysis, it is possible to conclude that the tribunal set a standard in which blocking a new competitor (even though it could be less efficient than the incumbent) is illegal, mainly because that blocking prevents the forces of market and competition from taking its course. If a new firm was allowed to enter the market and then foreclosed for being inefficient, no harm would have been done to competition.

20. Although the Tribunal did not develop numerical tests to achieve its conclusions, it is possible to do so in retrospective, using the following equation:

$$D_E = 1 - \frac{(1 - D_I) - S_I}{(1 - S_I)}$$

Where:

DI represents the exclusivity discount made by the incumbent

DE represents the discount needed by the entrant

SI represents the non-contestable market share of the incumbent

21. If we consider the market share of CCF between 2004 and 2006 (around 92%) as non-contestable, a competitor trying to enter the market serving the whole contestable share (8%) would have needed to offer a discount of 75% to overcome an exclusivity discount of 6%. In this particular case, an as efficient competitor would not have been able to enter the market, unless it was able and willing to sustain heavy losses.

22. This result, though, is based the strong assumption that the non-contestable share of the market is the same as the market share of CCF in previous years, or that somehow the consumers have a strong brand loyalty, which could or could not be the case with matches. No evidence was found on the Tribunal's decision suggesting either way.

5. Theory of harm

23. This case wasn't handled as a case of predatory practices in which the dominant position is used to expel competitors from the market and then, because of barriers to entry or fear of a similar future conduct, increase the prices to monopolistic levels, which could have been an alternative interpretation of the facts. Instead, it was handled as a case of anticompetitive rebates that themselves were artificial barriers to enter this market.

24. In that respect, the tribunal concluded that these discounts and rebates strategies were illegal only when they closed the market to new competitors, and that itself was enough to convict, without further analysis about the prices charged or the cost efficiency of possible new entrants. When the sales goals were considered low enough to allow for the entry of new competitors, the tribunal couldn't establish an anticompetitive intent, and didn't convict CCF for those contracts.

6. Efficiency considerations by the defendant

25. CCF stated that an equally efficient competitor could have entered the market offering the same discounts that they did (i.e. if they offered a 6% discount, a new entrant could have done so too) even considering the higher costs of importing versus producing matches.

26. This analysis wasn't explicitly considered wrong by the Tribunal, but new developments in economic theory show that this defense is wrong because it doesn't consider that a share (in this case, probably an important share) of the market is captive to the dominant firm, and that selling products from a different competitor could end up costing the distributor more than the discounts they could offer.

27. Thus, even a competitor that was more efficient than the incumbent could have been excluded if the contestable share of the market was low enough, invalidating the argument stated by the defendant.