

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

Competition Issues in Aftermarkets - Note from the European Union

21-23 June 2017

This document reproduces a written contribution from the European Union submitted for Item 4 of the 127th OECD Competition committee on 21-23 June 2017.

More documents related to this discussion can be found at

www.oecd.org/daf/competition/aftermarkets-competition-issues.htm

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JT03415870

European Union

1. Introduction

1. Aftermarkets are markets for the supply of products or services needed for, or in connection with, the use of what is often a relatively long-lasting piece of equipment that has already been acquired. This equipment is referred to as the 'primary product' (and hence its market is called 'primary market'). The complementary product(s) (typically spare parts or consumables) and services used in connection with the primary product are referred to as 'secondary products' (and their market is called 'secondary market' or 'aftermarket').

2. There are different points of view among market participants on whether there could be competition concerns, especially under Article 102 of the Treaty of the Functioning of the European Union ("TFEU")¹, when the producer of the primary product holds high market shares in the secondary market. These divergent views regarding aftermarkets were summarised in the XXVth European Commission Report on Competition Policy (1995)²:

'Producers of primary equipment argue that there cannot be dominance in secondary products if there is lack of dominance in the primary product market because potential buyers would simply stop buying the primary products if the prices for parts or services were raised. This theory implies a timely reaction on the primary product market due to consumers' ability to calculate the overall life-time costs of the primary product including all spare parts, consumables, upgrades, services, etc. It furthermore implies that price discrimination is not possible between potentially new customers and "old" captive customers or that switching costs for the latter are low. On the other hand, complainants who produce consumables or maintenance services assume dominance in the secondary product market if market shares are high in this market, i.e. this approach focuses only on the secondary products without analysing possible effects emanating from the primary product market.'

3. According to the European Commission ('Commission'), neither of these approaches reflected reality sufficiently. This prompted the need for a case-by-case analysis based on an in-depth fact-finding exercise. This was notably done in the *Pelikan/Kyocera* case (1999)³, where the Commission developed a dedicated analytical framework, based on economic thinking, which led to the elaboration of a test, known as the 'EFIM' test, which is still applicable today (see section 3).

4. Since *Pelikan/Kyocera*, there have been a number of cases dealt with by the Commission, where it was found that companies *may have* abused their dominant position on an aftermarket. All of these cases were resolved by the investigated parties

¹ Although infringements of Article 101 TFEU are not ruled out in aftermarkets, the present contribution only addresses situations relating to the application of Article 102 TFEU.

² http://ec.europa.eu/competition/publications/annual_report/1995/en.pdf

³ Rejection Letter of 22 September 1999 in Case No IV/34.330 – *Pelikan/Kyocera*.

offering commitments⁴. These were the *Novo Nordisk* case (1996)⁵ the *Digital* case (1997)⁶, and the *IBM Mainframes Maintenance* case (2011)⁷.

5. In contrast, the Commission has in other cases found that there was *no abuse* of aftermarket dominance where there were sufficiently strong links between primary and secondary markets and the primary markets were competitive. This led to rejections of complaints in the cases *Pelikan/Kyocera* (1999)⁸, *Info-Lab/Ricoh* (1999)⁹, *EFIM* (2009)¹⁰ and *Luxury Watches* (2007/2014)¹¹.

2. Market definition

6. Regarding market definition, debates within the competition community are usually focused on whether distinct primary and secondary markets exist or whether there is one overall 'system market'. This may be complicated by the fact that some focus the debate on the 'economic' meaning of 'separate markets' while others concentrate on the definition of separate markets according to the 1997 *Market Definition Notice*¹² (the 'Market Definition Notice').

7. In the Commission's practice, markets are defined according to the Market Definition Notice, which explicitly mentions aftermarkets. It specifies that when considering primary and secondary markets, in particular when an Article 102 assessment needs to be carried out, the methodology for defining markets has to be '*undertaken with care*'. While the usual market methodology to delineate markets applies¹³, constraints on

⁴ In these cases, the parties either proposed undertakings, prior to Regulation 1/2003 on the implementation of Articles 101 and 102 of the Treaty, or proposed commitments which were made legally binding under Article 9 of Regulation 1/2003.

⁵ See XXVth Report on Competition Policy (1996), §62, available at http://ec.europa.eu/competition/publications/annual_report/1996/en.pdf.

⁶ See Press Release IP/97/868 of 10 October 1997.

⁷ Commission Decision of 13 December 2011 in case 39.692 IBM Maintenance Services.

⁸ Rejection Letter of 22 September 1999 in Case No IV/34.330 – Pelikan/Kyocera.

⁹ Rejection letter of 7 January 1999 in case IV/E 2/36.431 – Info-Lab/Ricoh.

¹⁰ Rejection of complaint of 20 May 2009 in case COMP/C-3/39.391 EFIM and Judgment of the General Court of 24 November 2011, European Federation of Ink and Ink Cartridge Manufacturers (EFIM) v European Commission, Case T-296/09, EU: T:2011:693, confirmed by the Court of Justice Case on 19 September 2019, EFIM v Commission, Case C-56/12 P, ECLI:EU:C:2013:575.

¹¹ The Commission first rejected a complaint in 2007. The decision was annulled by the General Court on 15 December 2010 (case T-427/08), and subsequently the complaint was again rejected by the Commission in 2014.

¹² Commission Notice on the definition of relevant market for the purposes of Community competition law, OJ C 372, 9.12.1997.

¹³ The General Court emphasised in *Luxury Watches* that if certain economic operators are specialised and are active solely on the aftermarket of a primary market, this constitutes in itself a strong indication of the existence of a separate aftermarket (Judgment of the General Court of 15 December 2010, Confédération européenne des associations d'horlogers-réparateurs (CEAHR) v European Commission, Case T-427/08, paragraph 108, ECLI:EU:T:2010:517).

substitution imposed by conditions in connected markets also need to be taken into account.

8. It is true that a possible interdependence (or sufficiently strong links) between primary and secondary markets is relevant both at the stage of market definition and at the stage of assessing dominance.

9. Faced with a growing number of complaints about infringements in aftermarkets, the Commission confirmed in its 2005 *Discussion Paper on Exclusionary Abuses* (the '*Discussion Paper*')¹⁴ that it would define aftermarkets following the same methodology as used for the definition of a primary market – i.e. without regard to sales of the primary products to which they relate. The effects of the 'overall system' (i.e. whether markets are interdependent) would, according to the *Discussion Paper*, be taken into account in the dominance analysis.

10. The EU precedents on aftermarkets are consistent in applying the same criteria for defining a market and for assessing dominance, even though, based on the circumstances of each case, the assessment came to different outcomes in different cases.

11. It is however noteworthy that in all cases decided so far by the Commission, distinct markets were found, at least preliminarily in the context of Article 9 of Regulation 1/2003 decisions or rejections of complaints. The issue of interdependence in these cases was seen as an element to consider in the assessment of dominance on the secondary market. It should be noted that distinct aftermarkets were even found in cases where the existence of close interdependence with a competitive primary market led the Commission to conclude that there was no dominance in the secondary market¹⁵.

3. Dominance analysis

3.1. Background

12. If distinct primary and secondary markets have been defined as a first step, the issue of analysing potential dominance on the aftermarket arises. The question in most of the Commission's practice, so far, has been whether a non-dominant manufacturer of a primary product could be dominant with respect to a rather small secondary product market where it has a high market share.

13. Finding dominance on the secondary market implies an assessment of whether an increase in the price of secondary products would alter the purchasing patterns for the primary product within a reasonable time. If so, the threat of switching on the primary market would constrain behaviour on the secondary market and exclude dominance despite high market shares on the secondary market.

14. In 1995, the Commission developed a methodology for analysing dominance in aftermarkets in its *Pelikan/Kyocera* decision¹⁶. In aftermarket cases, the dominance analysis on the secondary market is linked to (a) the interdependence between primary and secondary markets and (b) to the competitive conditions on the primary market (that

¹⁴ DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses, 2005.

¹⁵ See cases quoted in paragraph 5.

¹⁶ See paragraph 3.

influence the reaction of customers in the primary market to potential exploitation on the secondary market). The logic of the methodology is based on the assumption that if a customer, when purchasing the primary product, takes into account all important factors relative to the secondary products and, at the same time, the primary market is sufficiently competitive for customers to be able to switch if there is a price increase of the secondary good, then aftermarket dominance cannot exist.

15. The analysis of (a) the degree of interdependence of separate markets is based on the extent to which a customer, when purchasing the primary product, takes into account all important factors relative to the secondary products. These factors include (1) the price and life-time cost of the primary product; (2) the transparency of prices of secondary products; and (3) the prices of secondary products concerned as a proportion of the primary product value.

16. Other criteria may also be taken into account, such as: (4) whether the primary product is usually purchased or hired; (5) whether the secondary product must be purchased on a continuous (foreseeable) basis; (6) whether price discrimination between old and new customers is possible; and (7) the number of potential new customers.

17. The analysis of (b) the competitive conditions on the primary market follows primarily the traditional approach of analysing customers' reaction to a (hypothetical) price increase of a specific primary good.

18. As explained, one needs to take into account the customer's awareness of lifecycle pricing for aftermarket products and services when purchasing the primary product and the potential costs of switching to an alternative primary product. On that basis, if primary and secondary markets form an interdependent system of markets and the primary market is competitive, then dominance cannot be established on the secondary market and thus there can be no aftermarket abuse.

3.2. The 'EFIM' criteria for assessing dominance on aftermarkets

19. The criteria for assessing dominance on aftermarkets were developed in cases concerning the printer cartridges market, starting with the *Pelikan/Kyocera* case and confirmed by the General Court in *EFIM*¹⁷. Kyocera, which held a relatively small market share on the printers market, was found not dominant on the secondary market for cartridges, where it had a somewhat high market share. The criteria developed in *Pelikan/Kyocera*, heavily inspired by economic thinking, were also applied in the 2009 printer cartridges case *EFIM*, which after confirmation by the General Court in 2011, lent its name to the test ('EFIM test')¹⁸.

20. The analysis was based on the assessment of whether the circumstances of the case allowed the assumption of a lock-in effect, i.e. the possibility for consumers to be exploited in the aftermarket. In order to conclude that the previously defined separate

¹⁷ Rejection of complaint of 20 May 2009 in case COMP/C-3/39.391 EFIM and Judgment of the General Court of 24 November 2011, *European Federation of Ink and Ink Cartridge Manufacturers (EFIM) v European Commission*, Case T-296/09, EU: T:2011:693, confirmed by the Court of Justice Case on 19 September 2019, *EFIM v Commission*, Case C-56/12 P, ECLI:EU:C:2013:575.

¹⁸ Rejection of complaint of 20 May 2009 in case COMP/C-3/39.391 EFIM and Judgment of the General Court of 24 November 2011, *European Federation of Ink and Ink Cartridge Manufacturers (EFIM) v European Commission*, Case T-296/09, EU: T:2011:693, confirmed by the Court of Justice Case on 19 September 2019, *EFIM v Commission*, Case C-56/12 P, ECLI:EU:C:2013:575.

markets are interdependent and competition on the primary market limits the market power of the producer of the primary good on the secondary market, four conditions needed be met. The questions to be answered under the EFIM test are:

- i. Can customers make an informed choice, including lifecycle-pricing, between the various manufacturers in the primary market?
- ii. Are they likely to make such choice accordingly?

If prices were raised significantly in the aftermarket,

- i. would a sufficient number of customers adapt their purchasing behaviour at the level of the primary market,
- ii. within a reasonable time?

21. Questions (i)-(ii) deal with the issues of (a) interdependence and (iii)-(iv) deal with (b) reaction of customers in the primary market to potential exploitation on the secondary market. If the answer to all four questions is 'yes', then there is no dominance on the secondary market. This means that the EFIM test provides step-by-step guidance to assess whether or not sufficient interdependence and a timely reaction on the primary market exists that can affect aftermarket dominance.

22. However, if the answer is 'no' to one of the questions, it does not automatically imply that the producer of the primary good is dominant on the aftermarket. In these cases a careful analysis that goes beyond the EFIM test needs to be carried out.

3.2.1. Interdependence of primary and secondary markets

23. In *Pelikan/Kyocera* it was concluded, when considering the degree of sophistication of customers and their likelihood to act accordingly (first two EFIM criteria), that the primary and secondary markets were sufficiently interdependent. This finding was especially based on the very high price ratio between the cost of the secondary product and the total cost of ownership of the primary product (70% in this particular case), which made it *'difficult to assume that a potential customer, either commercial or nonprofessional, would not carefully examine the entirety of costs which he will incur prior to the choice of that equipment'*¹⁹.

24. In the Commission's decisional practice, in all cases where it was found that the producer of the primary good was not dominant on the secondary market even though it had high market shares, there was strong interdependence between primary and secondary markets. The fewer the links between the two markets, i.e. the less a customer, when purchasing the primary product, takes into account all important factors relative to the secondary products, the more likely it is that aftermarket dominance may be found.

3.2.2. Reaction of customers in the primary market and switching

25. In the Commission's decisional practice, it has been concluded that dominance on the secondary market within an interdependent system of markets cannot be established if there is strong competition on the primary market and there are low barriers to switching. If there is no strong competition on the primary market or switching is difficult, dominance may be established on the secondary market and an abuse may exist.

¹⁹ *Pelikan/Kyocera*, §62.

3.2.3. *Distinction between existing and new customers*

26. When assessing the last two EFIM criteria, the distinction between old and new customers must also be taken into account. The rationale behind this is that while an assessment of life-cycle costs and of primary market competition may protect future customers, this will not be the case for existing customers if discrimination between future and existing customers is possible. In the absence of significant possibilities of customer discrimination, the 'installed base' (old customers, already supposedly 'locked-in') is protected from exploitative behaviour by new customers. In such a case, it is enough to establish that there are a sufficient number of potential new customers to fulfil this regulative function.

27. A supplier may change policy and raise prices in the aftermarket. Such 'installed-base opportunism' is more likely to take place where a supplier's prospects on the primary market are poor (for instance because the market is declining). However, even a supplier in these conditions may hesitate to engage in installed-base opportunism if such behaviour can hurt its reputation in other markets. Moreover, existing customers may also insure themselves against 'installed-base opportunism' by contractual safeguards (e.g. long-term service contracts, non-discrimination clauses or the possibility to switch to other suppliers of primary or secondary products).

4. Competitive assessment and priority setting considerations in aftermarket cases

28. In cases where separate markets have been defined and aftermarket dominance has been found, as set out above, the Commission will undertake the competitive assessment of the practices taking place in the relevant market. Depending on the theories of harm that may apply to the facts of a given case (e.g. refusal to deal or tying), the usual legal tests will apply when considering possible abuses. Some of the considerations relevant in the analysis of interdependence of primary and secondary markets (see section 3.1) may need to be taken into account in the competitive assessment, even if the interdependence is not sufficient to conclude on the absence of aftermarket dominance. For example, for the assessments of the effects of a potential abuse, effects on both the primary and secondary markets may be relevant.

29. In addition, there may be acceptable efficiency justifications for the conduct on the secondary market by the manufacturer of the primary good. Nevertheless, the burden of proof to show this is on the company. As in all of its cases, the Commission is always open to consider substantiated efficiency arguments when dealing with a case or deciding whether to pursue a case.

30. Finally the interdependence of primary and secondary markets can also play a role at the priority setting stage, i.e. when a competition authority balances the costs and benefits of an antitrust intervention in different potential cases.

31. It is sometimes argued, when considering purely price effects, that any price decrease on the secondary market might be offset by a price increase on the primary market under some conditions. This is what economic literature labels as the 'waterbed effect'. The reasoning might be seen, on first sight, as pleading against an antitrust intervention as the result thereof might be a mere modification of the price pattern between primary and secondary markets, while consumers would be essentially paying the same overall sums. This reasoning nevertheless assumes that any price decrease on the secondary market is entirely offset by a price increase in the primary market, and that

there are no other effects than price effects on the secondary market. Non-price effects may include effects on innovation that should be carefully evaluated. Therefore, antitrust intervention should not be automatically dismissed when primary and secondary markets are interdependent.