

## The Velux case – an in-depth look at rebates and more

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### 1. Introduction

*“The Polish window manufacturer, Fakro, which claims to be the world’s second largest producer of roof windows, alleges it has been squeezed out of certain European markets by Danish rival Velux. The Polish group claims its Danish rival used rebates and other commercial tactics to stop retailers stocking its products. It maintains that it has been unable to build a viable distribution system in some of the main European markets as a result – including the likes of France, Germany, the UK and the Netherlands. This, it says, has kept its market share in Western Europe at about 5 per cent, compared with around 17 per cent globally.”* (Financial Times, 6 July 2008)

In April 2007, the Commission opened an ex-officio case<sup>(2)</sup> to investigate alleged infringements by Velux in the roof windows market. Following one year and a half of analysis and inspections carried out at Velux premises in various Member States and at the premises of various distributors, the Commission could not confirm the allegations raised by the competitor and decided to close the case.

### 2. The product and the company investigated

Roof windows are specific products which in important aspects differ from vertical windows. The two types of windows cannot be considered as substitutes. The European Commission’s investigation focused on roof windows and accessories such as blinds (sunscreening), flashings, shutters and decoration devices.

Manufacturers concentrate production in certain plants and distribute all over Europe from central distribution locations. Such production organization is motivated by economies of scale which can be achieved through centralized manufacturing facilities. Although production is organized on a European level, Velux’ distribution system is organized on a national basis with often quite different rebate systems and promotion campaigns varying from country to country. Demand conditions are different across countries due to, for example, weather, density of housing, real estate and construction regulations. Furthermore, Velux’ smaller competitors

have quite different positions in different Member States. There are therefore elements that could point towards a national geographic market definition.

The company investigated is the Velux Group (hereinafter referred to as “Velux”), with head office based in Copenhagen. It is owned by VKR Holding, a limited company present in five business areas: roof windows and skylights, vertical windows, decoration and sunscreening, thermal solar energy and natural ventilation. Velux enjoys wide brand recognition and has a very strong position in the sales of roof windows and accessories in the EEA in general and in particular in each national market under investigation.

Velux also comprises RoofLITE, a company that serves the low-price and private label segments of roof windows.

### 3. Behaviour subject to investigation

The Commission decided to investigate whether certain of Velux’ practices result in anticompetitive foreclosure of its competitors. The Commission has explained its approach to assessing such practices in its “Guidance on the Commission’s enforcement priorities in applying Article 82 to abusive exclusionary conduct by dominant undertakings” (hereinafter referred as the Article 82 Guidance paper).<sup>(3)</sup> In the following we explain how the approach described in the Guidance paper was applied to the Velux case.

#### Rebates and other benefits for distributors

Velux’ rebate schemes and other benefits provided to its distributors might give disincentives for the distributors to switch, at least partially, to other roof windows manufacturers. Fakro stated that it had encountered difficulties in entering the markets in France, the UK and Germany as the building supply merchants are highly concentrated in these countries and Velux’ well established relationships with building suppliers impede Fakro’s access to the distribution networks.

Velux uses a system of numerous discounts and bonuses that vary from country to country. However, it does not seem that the schemes are individualised according to the needs and capacity of a given

<sup>(1)</sup> The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the authors.

<sup>(2)</sup> Case COMP/39.451 — Velux

<sup>(3)</sup> OJ C 45, 24.2.2009, p. 7.

en distributor within a given country, as the same trade conditions are offered to all distributors in that country. The analysis of the rebate systems was performed on the basis of documents provided by Velux and its distributors.

The Commission also decided to investigate whether Velux had offered other individualised benefits to distributors, beyond the official rebate schemes. The Commission took the view that the best way to uncover possible evidence of such behaviour would be through conducting inspections on the premises of Velux in Denmark and several other European countries, as well as on the premises of some of Velux' large distributors.

### RoofLITE — A fighting brand?

Besides its main brand Velux produces lower quality brands, RoofLITE for roof windows and Contrio for accessories. The Commission decided to investigate whether these were launched in order to exclude competitors (so-called fighting brands). The investigation focused on RoofLITE which is the more important of the two brands. The theory of harm would be that Velux might have deliberately incurred losses in the sales of RoofLITE beyond what is normal for a newly launched product, that is, that RoofLITE might have been used as a predation tool. Also for this theory of harm the Commission considered that conducting inspections searching for documents explaining the strategy behind the launch of the secondary brands and data concerning their profitability would be the best investigative strategy.

## 4. Results of the investigation

Having reviewed all the documents in its possession after conducting inspections, the Commission concluded as follows.

### Rebates and other benefits for distributors

Velux' discounts, bonuses and reimbursements are either included in the general trade conditions and offered to all distributors on the same terms or are stipulated in some special contracts for additional services rendered by distributors. The Commission's assessment indicates that neither Velux' current rebate scheme nor the individualised benefits lead to anticompetitive foreclosure of Velux' rivals.

Velux' uses a certain type of conditional rebates. Paragraph 37 of the Article 82 Guidance paper provides a definition for conditional rebates and explains the difference between retroactive and incremental rebates: "Conditional rebates are rebates granted to customers to reward them for a particular form of purchasing behaviour. The usual nature

of a conditional rebate is that the customer is given a rebate if its purchases over a defined reference period exceed a certain threshold, the rebate being granted either on all purchases (retroactive rebates) or only on those made in excess of those required to achieve the threshold (incremental rebates). Conditional rebates are not an uncommon practice. Undertakings may offer such rebates in order to attract more demand, and as such they may stimulate demand and benefit consumers. However, such rebates – when granted by a dominant undertaking – can also have actual or potential foreclosure effects similar to exclusive purchasing obligations."

Velux uses incremental rebates which are described in the general trade conditions. They vary somehow from country to country but the general principles are similar. Bonuses are applied to total turnover over a period of time, normally six months. The maximum turnover bonus is around 5%. There are up to 20 steps in a discount function. The increments are quite small, of the order 0.2-0.5%. If the turnover is above the threshold of a given step, the discount increases marginally and the higher discount is applied only to the part of turnover exceeding the previous step.

It is fairly easy to see that it is unlikely that Velux' incremental rebate schemes could be anticompetitive. As Velux' exact trading conditions are confidential, we instead provide a simple example. In this hypothetical rebate scheme there are ten steps where each step gives an extra 0.5% rebate so that the maximum rebate that can be reached is 5%. The first rebate is given if the distributor sells more than 99 windows, and an extra 0.5% is given for each extra 100 units sold. The maximal discount of 5% is given if a distributor sells more than 1000 units. To illustrate, assume that the standard price without rebate paid by distributor (which equals the price paid for the first 99 units) is EUR 100.

With such an incremental rebate scheme the first thing to look at is the highest discount given. In our example this is 5%, implying that distributors pay EUR 95 for all (extra) windows once they have bought more than 1000 windows. It seems quite likely that a price of 95 would cover Velux' incremental costs if the "headline price" of 100 does so. For price-based practices such as rebates the Guidance states that "the Commission will normally only intervene where the conducts concerned has already been or is capable of hampering competition from competitors which are considered to be as efficient as the dominant undertaking."<sup>(4)</sup> In this case an equally efficient entrant or a small competitor competing on the margin for the last 100 windows sold would likely be able to match the discounted

<sup>(4)</sup> Guidance, paragraph 23.

price of EUR 95. The conclusion is therefore that it seems unlikely that such a rebate scheme would be exclusionary.

It is important to compare the discount with the correct benchmark. A variation of the above scheme could be that the discount is given on the turnover of the distributor and the EUR 100 in reality is a kind of recommended list price. Assume further that to incentivize greater effort on the part of the distributor each distributor gets a standard 20% rebate on the list price, which would be her basic margin. In such a scenario, the incremental rebate should be compared to the price net of the 20% general rebate. The top 5% discount will then in reality amount to a 6.25% discount on the normal purchasing price for a distributor of EUR 80 per window. In our example, the conclusion would again be that it is unlikely that such a system would be exclusionary.

Finally, elements containing individual targets amount to a very small proportion of the total turnover and cannot be considered to have exclusionary effects, especially when taking into account the scale of operation of distributors.

### A digression on retroactive rebate schemes

Although Velux' rebate scheme is based on incremental rebates it is interesting to consider how to analyse a similar retroactive rebate scheme, where the discount corresponding to the last step reached is applied to all units purchased. The following paragraphs explain how to examine this particular type of conditional rebate system using the principles set out in the Commission's Article 82 Guidance.<sup>(5)</sup>

Paragraph 40 of the Guidance states that “[i]n general terms, retroactive rebates may foreclose the market significantly, as they may make it less attractive for customers to switch small amounts of demand to an alternative supplier, if this would lead to loss of the retroactive rebates. The potential foreclosing effect of retroactive rebates is in principle strongest on the last purchased unit of the product before the threshold is exceeded.”

The methodology is further explained in paragraph 41: “[t]he Commission will estimate what price a competitor would have to offer in order to compensate the customer for the loss of the conditional rebate if the latter would switch part of its demand (‘the relevant range’) away from the dominant undertaking. The effective price that the com-

petitor will have to match is not the average price of the dominant undertaking, but the normal (list) price less the rebate the customer loses by switching, calculated over the relevant range of sales and in the relevant period of time”. Paragraph 43 adds that “[t]he lower the estimated effective price over the relevant range is compared to the average price of the dominant supplier, the stronger the loyalty-enhancing effect.”

We could extrapolate the figures in the example provided above to create a hypothetical illustration for the case of retroactive rebates. Assume, as above, that the standard price paid by a distributor (which equals the price paid for the first 99 units) is EUR 100. Then a distributor buying 99 windows will pay EUR 9900, while she will only pay EUR 9950 if she buys 100 windows, since she now gets a discount of 0.5% on all 100 windows. The average price of the first 100 windows is therefore EUR 99.50 while the marginal price for window number 100 only is EUR 50. For rebate systems with larger discounts the marginal price may even become negative, which is sometimes used to argue that it is impossible for alternative producers to compete against such a rebate system. However, often it does not make much sense to focus on the marginal price, since alternative producers typically will try to sell more than one unit to a given distributor. The Commission's Article 82 Guidance introduces the concept of a “relevant range” that alternative producers will try to compete for<sup>(6)</sup>. It is often relatively simple to conclude that a generalized rebate system is unlikely to be exclusionary without establishing precisely what the relevant range is. In the present example, one could, for instance, calculate what the “effective” price a distributor pays for a given “step” is. For example, if a distributor buys 1000 windows instead of 900, what is the effective average price that the distributor pays? It is easy to see that, taking account of the 4.5% rebate, the distributor would pay EUR 85 950 for buying 900 windows. The total price for 1000 windows would be EUR 95 000 after benefitting from a 5% discount. The effective average price for the 100 windows would therefore be  $(95\ 000 - 85\ 950) / 100 = 90.5$ . This is the lowest average price a distributor would pay for a full “step” of 100 extra windows. This “step average” price decreases steadily with EUR 1 per step from 99.5 for

<sup>(5)</sup> It is important to note that the below considerations do not relate to rebates conditional on the customer obtaining all or most of his requirements — whether the quantity of his purchases be large or small — from the dominant company. It is beyond the scope of this article to deal with such rebates.

<sup>(6)</sup> Paragraph 42 of the Guidance states that “the relevant range over which to calculate the effective price in a particular case depends on the specific facts of each case and on whether the rebate is incremental or retroactive. For incremental rebates, the relevant range is normally the incremental purchases that are being considered. For retroactive rebates, it will generally be relevant to assess in the specific market context how much of a customer's purchase requirements can realistically be switched to a competitor (the ‘contestable share’ or ‘contestable portion’).”

the first 100 windows to 90.5 for the last 100 (from 900 to 1000). In this particular example where the rebate function exhibits numerous very small steps and a relatively low highest rebate of 5%, the effective unit price for the relevant range of EUR 90.5 seems sufficiently high to cover incremental costs.<sup>(7)</sup> Most manufacturers probably have a margin higher than 10%, although this may not be true for all industries. It therefore seems unlikely that such a retroactive rebate system would be exclusionary.

Indeed, the Guidance acknowledges that “as long as the effective price remains consistently above the LRAIC (long run average incremental cost) of the dominant undertaking, this would normally allow an equally efficient competitor to compete profitably notwithstanding the rebate. In those circumstances the rebate is normally not capable of foreclosing in an anti-competitive way”<sup>(8)</sup>. The case would be different if the effective price were below the average avoidable cost. As a general rule, in this case, the rebate scheme would be capable of foreclosing even equally efficient competitors.

It should be noted that it may be the case that the “relevant range” is smaller than the size of the steps. In the example above, it might be concluded that a competitor realistically can only hope to compete for 50 windows instead of 100. In that case the lost rebate has to be “spread” over 50 units instead of over 100 and the price the competitor has to offer in order to compete for the 50 windows would be correspondingly lower.

## RoofLITE

Concerning the possibility of Velux using fighting brands, the investigation did not find any evidence of a strategy to exclude competitors. Furthermore, there were no indications that rivals exerting or having the potential to exert any significant competitive constraint on Velux’ premium brand were foreclosed or marginalised from the market. In fact, the

introduction of RoofLITE in the low-cost segment of the market was a natural response to increased competition from private labels and generic goods from China. The resulting increased competition in the lower segment of the market is likely to have led to downward pressure on prices thus benefitting consumers.

With respect to rebates RoofLITE operates in a different way than the Velux brand in that it does not have a generalised rebate scheme, as is the case for Velux. Rather, prices are negotiated on an individual basis. This reflects the nature of competition in the low cost segment which seems to function on a basis similar to tenders. Producers are bidding for the right to sell their low cost products in a certain hard discounter, often as a “second brand” next to a higher priced brand such as Velux. Manufacturers therefore have to adjust their conditions according to the bidding process.

## 5. Conclusion

This case shows how the approach advocated in the Commission’s Article 82 Guidance paper can be applied in practice. The Guidance paper states that “the Commission will focus on those types of conduct that are most harmful to consumers”.<sup>(9)</sup> In this case the Commission’s investigation showed that Velux had designed a conditional rebate system without any anticompetitive foreclosure effects, that is, competitors were not foreclosed in a way that could cause likely harm to consumers. Similarly, the other theory of harm related to predatory pricing through fighting brands was not confirmed by the investigation. The introduction of RoofLite did not foreclose or marginalise important rivals and did therefore not allow Velux to profitably increase prices to the detriment of consumers.<sup>(10)</sup> In line with the enforcement priorities set out in the Article 82 Guidance paper the Commission therefore decided to close the case.

<sup>(7)</sup> See also paragraph 40 of the Guidance: “The higher the rebate as a percentage of the total price ... the stronger the likely foreclosure of actual or potential competitors”.

<sup>(8)</sup> Guidance, paragraph 43.

<sup>(9)</sup> Guidance, paragraph 5.

<sup>(10)</sup> Guidance, paragraph 19.