



## WHITE PAPER

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### Chinese Antitrust Enforcement Against Tying, Exclusive Dealing, and Loyalty Discounts

Recent antitrust enforcement activities by China's State Administration of Industry and Commerce ("SAIC") indicate that aggressive actions against "single firm" conduct—that is, actions taken by a single business, not in coordination with others—will continue. The SAIC's decision reveals an emphasis on violations involving tying arrangements, exclusive dealing, and loyalty discounts. Companies with substantial market shares in China might consider reassessing the antitrust risks for certain practices, and in some cases should contemplate an adjustment of business models and market strategies.

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Recent antitrust enforcement activity in China signals continued aggressive enforcement against “single firm” conduct—that is, actions by a single business, not in coordination with others.

On November 9, 2016, the State Administration of Industry and Commerce (“SAIC”), the Chinese antitrust agency responsible for enforcement against non-price-related anti-monopoly conduct, imposed a RMB 667.7 million fine (US\$100 million) on Tetra Pak and its Chinese subsidiaries (“Company”) (the SAIC penalty decision on the Company hereinafter “Decision”). According to SAIC, the Company abused its dominant position by means of tying, exclusive dealing, and loyalty discounts, violating China’s Anti-Monopoly Law (“AML”). The conduct found to be abuses of dominance included incentives the Company employed—performance testing, liability of warranty, accumulative volume discount, and customized purchase requirement—to encourage customers that owned or leased the Company’s packaging equipment to use the Company’s own packaging materials and aftermarket service.

The Decision indicates that Chinese enforcement will continue in the area of single firm conduct, following on a record fine for price-related conduct, unfairly high licensing fees, and bundling imposed on another company by the National Development and Reform Commission (“NDRC”), a Chinese enforcement agency, and another Chinese antitrust agency.

## **APPROACH TO MARKET DEFINITION AND DOMINANCE**

The Decision found abusive behaviors in three relevant product markets: aseptic packaging equipment of paper-based composite materials for liquid food (“Packaging Equipment”), technical services for such Packaging Equipment (“Technical Services”), and paper-based composite material of aseptic packaging for liquid food (“Packaging Materials”). The relevant geographic scope of all relevant markets was mainland China.

### **Packaging Equipment, Aftermarket and Packaging Materials as Separate Relevant Markets**

The Decision is inconsistent in its approach to market definition. For example, SAIC observed that “when selecting packaging method, liquid food manufacturers consider as a whole the selection of Packaging Equipment, Technical Services and Packaging Materials from the perspectives of technical features, system cost and others.” However, SAIC defined

separate product markets for each of Packaging Equipment, Technical Services, and Packaging Materials. The competition at the system level was not considered as a competitive constraint when discussing the competition conditions in the Technical Services and Packaging Materials market.

When considering whether other packaging materials (plastic, metal) were substitutes with paper-based composite materials for liquid food, SAIC noted that different liquid food had different requirements for packaging materials, and other materials could not cover all the areas for which paper-based composite materials were used. It further noted that Packaging Equipment is very expensive, and the switching cost for manufacturers is high.

When considering aftermarket services, SAIC included services provided by all equipment providers rather than narrower brand-specific services markets (e.g., a market for servicing of the Company’s branded Packaging Equipment). SAIC came to this conclusion despite finding no third-party service providers that are dedicated to providing aftermarket services for the Company’s equipment. Given that spare parts, in particular the core parts, were provided by the Company only to its own customers, it would be difficult, if even possible, for any third-party service providers to provide repair and maintenance service on the Company’s Packaging Equipment. The Decision mentioned that customers could do everyday simple maintenance but had to rely on the Company for overhauling. This approach contrasts with earlier NDRC horizontal collusion and resale price maintenance cases involving automobiles and aftermarkets, in which NDRC did not take a position on relevant markets, as well as with a decision by the High People’s Court of Hunan Province, determining the relevant market to be door locks compatible with the specific vehicle at issue.

China’s approach appears to be similar to that of European Union. The focus of the EU analysis is to verify whether prices in the aftermarket act as a competitive constraint on the consumer’s decisions in the primary market. If a sufficient number of consumers would switch to other primary products in the event of a moderate and permanent price increase on the aftermarket, the European Commission would likely treat the primary and aftermarket as a single unified “systems market.” In contrast, under U.S. antitrust law, cases finding violations for constraints imposed by the equipment manufacturer on the service and materials that work with its equipment are rare. The

plaintiff would have to show that customers were locked in to the particular equipment because customers were not able to predict the life cycle cost of the restraints, or the restraints were imposed later, and the cost of switching brands was prohibitive.

### **Higher-than-Average Margins and Prices as Evidence of Dominance**

The Decision indicates that SAIC appears to place substantial emphasis on high margins and prices in addition to market shares in determining market dominance. The Decision indicated that the Company had shares ranging over 50 percent in Packaging Equipment, over 80 percent in Technical Services, and over 60 percent in Packaging Materials. In finding a dominant position in each of the relevant markets, SAIC made multiple references to margins and prices as important factors in addition to market share. In particular, in low-end, low-speed Packaging Equipment, a segment in which the Company had lost its advantage and faced competitive pressure, SAIC still found that the Company's increasing profit margins indicated "relatively strong market power" and a "lack of competition constraint." Similarly for Packaging materials, SAIC cited as evidence of dominance that, during 2009–2013, the Company's gross margin was higher than that of its competitors, and the price of the Company's Packaging Materials also was higher than industry average.

The Chinese AML was modeled largely after the EU competition law, where a finding of dominance is based on a combination of factors, including pricing constraints and margins, countervailing buyer power, and threat of entry. Market shares, which are the primary indication to assess market power, are to be interpreted in light of these broader market conditions. High margins are considered a relevant factor to assess dominance.

### **Reliance by Customers as Evidence of Dominance**

The Decision also examined reliance by customers on the Company's products, but when looking at whether substitutes were available, SAIC appeared to focus on narrower market segments where there were few competitors. For example, in the case of Packaging Equipment, SAIC found that large customers needed high-speed Packaging Equipment, which was available only from a few suppliers. In the case of Packaging Materials, SAIC found that the Company provided more shapes and specifications of packages, which created added value for the packaged products, whereas domestic Chinese

suppliers could manufacture only brick-shaped and pillion-shaped packaging, due to patent protections.

As a matter of policy, customer stickiness due to high quality and versatility of product choices should be encouraged by competition law rather than being considered as evidence of market power or dominance. This may be a positive evidence of competition unless those dedicated customers constitute a separate relevant market.

### **Impact of Not Making Spare Parts and Technical Training Freely Available**

In its analysis of the Company's dominance in the service aftermarket, SAIC found that entry barriers were high, noting that the Company "only provided spare parts to its customers" and "technical training was only open to its customers." The unavailability of parts and technical training to third-party service providers was viewed as hampering their ability to enter the aftermarket. It is not clear whether the Decision indicates that SAIC views dominant firms as having the obligation to make available spare parts and even technical training to potential or actual third-party service providers.

## **TYING VIOLATIONS**

In the Decision, SAIC found several behaviors to be improper tying and thus, in light of the Company's allegedly dominant market positions, abuse of dominance. It is noteworthy that, with regard to all of the tying allegations, the Company's contracts appeared to allow customers to use not only the Company's own Packaging Materials but also Packaging Materials "certified by the Company," "of the same quality," or "meeting the minimum standard." In fact, according to SAIC, most customers maintain a dual-supplier sourcing strategy for Packaging Materials. Nevertheless, SAIC appeared to focus on actual effect rather than contract language and thus found de facto tying violations in each scenario as detailed below. Moreover, various business justifications offered by the Company—such as guaranteeing performance of equipment, identification of product liability, food safety, and protection of its leased equipment—were not recognized by SAIC.

EU law has generally been more restrictive in relation to pure tying practices, i.e., practices that leave no flexibility to the customer to not purchase tied products, unless it can be proven

that the products should be considered a “single” product. In relation to mixed bundling practices, which leave an element of customer choice (for the stand-alone or combined product), the approach is more economic-based and assesses the replicability of the bundle.

U.S. law is much more tolerant of tying than are laws in other jurisdictions. A seller may violate U.S. antitrust law if it ties competitive goods (tied product) to its non-competitive goods (tying product) and therefore forecloses rivals selling the tied product from a substantial part of the market, thereby preventing those rivals from effectively competing and giving the seller market power in the tied product market as well.

#### **Tying Packaging Materials to Packaging Equipment During the Warranty Period**

The Company's purchase contracts restricted purchasers to using only the Company's Packaging Materials or Packaging Materials of the same quality during the equipment warranty period. Otherwise, the Company would not bear responsibility for repair or replacement.

SAIC took the view that although the contract allowed purchasers to use Packaging Materials “of the same quality,” practical obstacles prevented or discouraged customers from using third-party Packaging Materials. For example, according to SAIC, the Company never voluntarily disclosed its technical specifications or explained what “the same quality” meant. Moreover, even if provided the technical specifications, customers would tend to use the Company's Packaging Materials, due to the uncertainties of testing and evaluation of the results and potential disputes regarding performance and warranty. The purchase contracts used by the Company after 2012 removed the above requirements and instead allowed Packaging Materials “complying with the minimum specification standard,” but listed only a QSV code, an internal standard of the Company, to illustrate the minimum standard. SAIC viewed this as an inducement to use the Company's Packaging Materials.

It is not clear from the Decision whether SAIC intends to impose an obligation on dominant equipment providers to list only industry-wide or otherwise nonproprietary standards or specific materials or disposables in such minimum specification standards.

SAIC appeared to take an approach consistent with that taken by the EU Commission with respect to vehicle manufacturers' warranty in the Motor Vehicle Block Exemption Regulation. Under that regulation, tying can constitute an abuse when the two products are distinct and consumers would consider purchasing the tying product without also buying the tied product from the same supplier. The manufacturer is nonetheless allowed to tie the warranty of specific products to the use of specified replacements, if the restraint on competition has a legitimate objective and is ancillary and proportionate.

#### **Tying Packaging Materials to Packaging Equipment During Performance Testing**

The Company's purchase contracts restricted the purchasers to using only Packaging Materials produced or otherwise certified by the Company during performance tests conducted to confirm whether the equipment met the performance targets indicated in the purchase contracts. Otherwise, the Company would not guarantee the performance targets, while the purchasers could claim damages from the Company if the performance of the equipment was below target. SAIC indicated that requiring testing performance tied to specific Packaging Materials was not consistent with custom in the industry. Investigation by SAIC further indicated that using Packaging Materials provided by third parties on the Company's Packaging Equipment yielded the same mechanical efficiency/performance. Moreover, SAIC concluded that using third-party Packaging Materials with the Company's Packaging Equipment would not necessarily affect the ability to properly identify liability in the case of any accident.

#### **Tying Packaging Materials to Aftermarket Services for Packaging Equipment During Performance Test**

According to the Decision, the service contract provided by the Company during 2009–2010 adopted a fixed cost maintenance service model (“FCMS”) where maintenance, repair, and replacement services were provided at a fixed rate based on the consumption of Packaging Materials (1,000 packs). The Company removed the requirement of using the Company's Packaging Materials in its service contract after 2011. It is not clear from the Decision whether there were alternative service models available to customers. SAIC took the view that Packaging Materials were standard products and their impact on the Packaging Equipment was stable and within a certain

range. Restricting the use of Packaging Materials to those provided by the Company was unnecessary from a technical perspective and not otherwise justified.

### **Tying Packaging Materials to the Lease of Packaging Equipment**

A further issue was whether the Company improperly required customers leasing its Packaging Equipment to use only its Packaging Materials. According to the Decision, the Company required the lessee to use its Packaging Material or Packaging Material of same quality in order to protect the value of its Packaging Equipment. SAIC took the position that, as long as the wear and tear on Packaging Equipment was within a normal range, a lessee should have the right to choose which Packaging Materials it wishes to use. SAIC thus concluded that tying Packaging Materials to the lease of Packaging Equipment unreasonably interfered with the right of use of the lessee and was inconsistent with industry custom.

This is consistent with a trend we have been seeing with both SAIC and NDRC of questioning the basis for linking equipment to aftermarket consumables/parts/service and apparently trying to separate equipment markets from aftermarkets. As illustrated by NDRC's draft Antitrust Guidelines in the Automobile Industry, which aim to bring more competition in the service market, parts, diagnosing tools, and technical materials may need to be open and available to all third parties, not merely to customers.

### **EXCLUSIVE DEALING VIOLATIONS**

SAIC also found the Company had abused its dominant position in the Packaging Materials market by indirectly imposing exclusive dealing obligations on its raw material supplier.

As explained in the Decision, base paper is the core raw material for Packaging Materials, accounting for more than half of the cost of the finished product. Base paper generally can be segmented into white back paper and kraft back paper. SAIC found that kraft back paper was superior to white back paper in terms of cost and performance. Zhuhai S.E.Z Hongta Renheng Paper Co. ("Hongta") was the only bulk supplier of kraft back paper in mainland China until 2014.

In an agreement for joint development of kraft back paper, Hongta agreed it would supply kraft back paper exclusively

for the Company. In a 2012 supply agreement between the Company and Hongta, the exclusive language was gone, but Hongta was prohibited from using certain technical information of the Company for the supply of kraft back paper to third parties. SAIC found this requirement to constitute abuse of dominance through exclusive dealing:

1. **Hongta owned patents for production of kraft back paper before it began cooperation with the Company.** The Company did not license any patents for the production of kraft back paper to Hongta.
2. **Hongta's supply of kraft back paper to third parties would not affect its cooperation with the Company.** According to SAIC's investigation, the supply of kraft back paper largely depended on the R&D and production of the supplier, with customers only providing parameters according to their own preferences and not any proprietary technologies or other necessary contributions. As a result, SAIC found that Hongta's providing kraft back paper to other customers would not adversely affect the Company.
3. **The provided technical information was not proprietary to the Company.** SAIC further found that, although described under the name of "joint development," much of the purported technical information provided by the Company to Hongta was merely specifications for the Company's Packaging Materials or industry knowledge that was not proprietary to the Company. As a result, SAIC decided that the Company did not have the right to restrict its supplier's use of such information.
4. **De facto exclusive dealing harmed market competition.** Despite its actual nonproprietary nature, SAIC found that the Company technical information was necessary for Hongta to supply kraft back paper with acceptable quality, so that the use restrictions placed by the Company on such technical information effectively restricted Hongta's capability to supply kraft back paper to customers other than the Company. In addition, despite the absence of the exclusive requirement in the contract since 2012, the fact that Hongta in fact supplied kraft back paper only to the Company and not other customers during the relevant period, even though Hongta had excess capacity at the time, proved that Hongta's ability to supply third parties had been restricted.

As a result, SAIC decided that such restrictions gave rise to foreclosure effects in the supply of raw materials, which would restrict competition in the market for Packaging Materials.



Similarly in the European Union and United States, such a practice may also violate antitrust laws where a buyer uses contractual restrictions to prevent the supplier of an important input from selling to the buyer's competitors, thereby foreclosing the competitors from the needed input and preventing them from effectively competing against the buyer.

## LOYALTY DISCOUNT VIOLATIONS

A third type of issue that arose in SAIC's investigation involved the Company loyalty discounts. Although such practices are not explicitly listed as prohibited abuses of dominance under the AML itself, the concept that they might constitute a form of prohibited exclusive dealing was introduced in article 14 of NDRC's Anti-Price Monopoly Regulation: "without valid qualification, an undertaking with a dominant market position shall not restrict, by means of price discounts or otherwise, the trading counterparty to trade exclusively with it or another undertaking designated by it." However, in the Decision, SAIC instead treated loyalty discounts under the AML's catch-all clause, article 17.1(7), which prohibits "other forms of abuse as recognized by the antitrust authorities."

SAIC found that the Company implemented two types of loyalty discount: (i) sales-based retrospective and accumulative discounts ("RAD") and (ii) customized sales target discounts ("STD"). RAD is a type of discount that applies retrospectively to the total purchase price across the customer's purchase volume over a certain period of time once that total volume reaches certain thresholds: the higher the threshold the customer reaches, the higher the discount. STD, on the other hand, is a discount granted for reaching a target that is customized to a particular customer. In addition to the loyalty discounts, the Company also implemented various other forms of discounts.

Although SAIC recognized in the Decision that discounts are a common commercial practice that may provide procompetitive benefits, including to consumers, it also pointed out that when combined with dominant market position and specific market conditions, such discounts can be anticompetitive.

SAIC found the loyalty discounts implemented by the Company to be anticompetitive on the following grounds:

### The Loyalty Discounts Had Exclusivity-Inducing Effects

As part of its analysis of these loyalty discounts, SAIC further distinguished between "contestable" and "uncontestable" demand. Uncontestable demand referred to the part of demand that could be supplied only by the dominant supplier for various reasons, while contestable demand referred to the part of demand that could be supplied by both the dominant supplier and other suppliers. SAIC pointed out that uncontestable demand was usually created by customers' reliance on the dominant supplier in terms of IP/technology, capacity, contractual obligations, and other aspects of overall influence.

SAIC decided that the RAD discount program was different from normal volume loyalty discounts because it applied retrospectively to a customer's entire purchase volume, covering products already purchased prior to achieving eligibility for the discount. In contrast, normal volume discounts applied only to incremental purchases after exceeding the purchase volume thresholds required to qualify for the discount. As a result, when the purchase volume of a customer approached the RAD threshold, purchasing more of the Company's product might end up resulting in a lower total price for the customer, thus inducing the customer to purchase more or exclusively from the Company.

According to SAIC, STD discounts locked in customers with customized target in terms of purchase volume or percentage setting at the customer's specific required volume (e.g., based on last year's purchases, or their forecasts) and thus effectively converted "contestable demand" to "uncontestable demand."

### Obvious Anticompetitive Effects in Light of Specific Market Conditions

SAIC then found the market conditions in the relevant markets likely to result in anticompetitive effects due to these loyalty discounts because: (i) some customers relied on the Company in meeting their requirements as to product offerings or purchase volume since other suppliers might not have been able to meet the requirement due to limited capacity and product offerings, (ii) the Company's tying of Packaging Materials to its sales of equipment converted part of contestable demand into uncontestable demand, and (iii) the Company's combined use of RAD, STD, and other discounts had further strengthened their anticompetitive effects.

SAIC decided that the above market conditions gave rise to anticompetitive effects because, in order to compete with the Company for any purchase volume, the Company's competitors not only had to offer similar pricing to that offered by the Company but also had to offer additional discounts to compensate customers for their loss of RAD discounts had the customer purchased the extra volume from the Company instead. According to SAIC, this anticompetitive effect was also proven by the fact that whenever the Company promoted a RAD plan, its sales increased substantially.

### **The Loyalty Discounts Restricted Competition in the Market of Packaging Materials**

SAIC also reasoned that the Company's loyalty discounts forced its competitors to compete by offering bigger discounts not only to meet the discounts offered by the Company but also to compensate the loss of the customers for purchasing less from the Company. Although this might benefit customers in the short term, in the long run SAIC believed it would squeeze out equally efficient competitors of the Company and thus reduce their ability and motivation to supply customers, resulting in a reduction in competition in the future that would damage customers. SAIC also pointed out that the fact that domestic suppliers in China failed to grow substantially during 2009–2013, despite the rapidly increasing demand, proved the existence of anticompetitive effects described above. Impact on domestic Packaging Materials suppliers is another important factor in considering the anticompetitive effect of the Company's conduct.

U.S. standards on loyalty discounts are not definitively established. With respect to discounts that have a loyalty-inducing effect, such as the use of customer targets, EU rules require that all relevant circumstances be considered in order to determine whether the discount scheme is abusive. Circumstances may include the setting of individualized targets, lack of transparency, calculation of the rebate scheme, and the length of the reference period. SAIC appears to follow in concept the "as-efficient competitor test" in the Post Denmark II ruling by the Court of Justice. The SAIC Decision did not list all the factors it considered in finding the customer target discount to be abusive.

## **SOME KEY TAKEAWAYS**

The Decision sheds some light on the agency's thinking in antitrust enforcement against tying, exclusive dealing, and loyalty discounts. Companies with substantial market shares may need to reassess the antitrust risks for the following practices in China and consider adjusting their practices to lower potential legal risks, particularly:

- Linking the sale of consumables, aftermarket services, and equipment
- Restrictions on warranty provisions and leasing
- Restrictions on access to spare parts and technical information
- Restrictions on suppliers of raw materials
- Use of retrospective, cumulative, and customized discounts

In the policy context of opening up aftermarket, any linking of equipment to aftermarket consumables/parts/service would look suspicious in the eyes of Chinese antitrust enforcers. Parts, diagnostic tools, and technical materials may need to be open and available to all third parties, not merely to customers. This may lead to adjustment of business models or strategies for the health care, automobile, and other industries.

Another notable issue is that SAIC appeared to focus on actual effect rather than contract language when finding violation of tying and exclusive dealing. Cleanup in the contract language without actual change of business practice may still be exposed to antitrust risks.

Moreover, various business reasons offered by the Company for its practices—such as guaranteeing performance of equipment, identification of product liability, food safety, and protection of its leased equipment—were not recognized by SAIC. Therefore, any justifications used as a defense for certain business practices need to be substantiated for them to be accepted by the antitrust regulator as "valid business justifications."

Lastly, the agencies may use catch-all provisions to define new violations, as they did for loyalty discounts without prior warning to companies and with retroactive application.



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