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ANNUAL REPORT ON COMPETITION POLICY DEVELOPMENTS IN ICELAND

--2015--

29-30 November 2016

This report is submitted by Iceland to the Competition Committee FOR INFORMATION at its forthcoming meeting to be held on 29-30 November 2016.

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EXECUTIVE SUMMARY

1. The current policy objectives of the Icelandic Competition Authority (ICA) are to contribute to increased competition in the domestic sector and public services. Comparison with neighbouring countries shows that the domestic sector in Iceland is lagging behind in terms of productivity. As to the public sector, the ICA advocates for competition incentives being used to increase efficiency and quality in public services, without disturbing equal access regardless of financial or social status. (Chapter 2)

2. The ICA is conducting a market investigation into the fossil fuel market in Iceland. According to the preliminary findings, there are signs of restrictions to competition in important sections of the market. The ICA has received extensive feedback and responses to the preliminary report. It is now taking a decision on whether the identified circumstances and conduct that raised competition concerns still exist and, if so, whether it is necessary to take action against the circumstances or conduct that disrupts competition to the detriment of public interest (Chapter 2.1)

3. The ICA is increasingly concerned about the level of common ownership of Icelandic undertakings and its effect on competition. Competitors in many significant markets are owned by a number of minority shareholders, each of them holding shares in more than one competitor in a given market. There are indications from recent researches that such common ownership could anti-competitively lead to higher prices. The Authority intends to follow this issue closely and welcomes any input from other competition agencies. (Chapter 2.2)

4. The ICA has fined MS (dominant Icelandic dairy) for abusing its dominant position in the market, by selling its competitors basic raw material for the production of dairy products at an abnormally high price, while at the same time, MS and associated parties were sold the same raw material at a much lower price, and, additionally, below cost of production. (Chapter 2.3)

5. Late 2015, the ICA started a special advocacy initiative through a series of meetings, held under the heading ***“Let’s talk about competition”***. The following issues have been covered so far (see chapter 2.4):

- *Competition and the Public Sector – Competition Assessment (OECD):* Keynote speaker was Ania Thiemann, Head of Global Relations at the Competition Division of the OECD.
- *Competition in Agriculture.* Panel discussion with stakeholders.
- *Enforcing EEA Competition Rules in Iceland:* Keynote speaker was Gjermund Mathiesen, Director of Competition and State Aid at EFTA Surveillance Authority.
- *Ownership of Undertakings – The Role of Pensions Funds and Competition:* Prepared with the assistance of Martin C. Schmalz, phd. University of Michican (Skype interview).

6. Other key initiatives in 2015 (see chapter 3.5):

- Investigation into the payment market concluded.
- A report issued on the groceries market.
- Investigation into two hard ware stores concluded.

- Formal opinion published on the slot allocation at Keflavik Airport.

7. By taking up more stringent prioritisation criteria, the ICA has managed to decrease the number of pending cases considerably. Through tougher prioritisation, the ICA is working towards decreasing the average case duration. (Chapter 3)

1. Competition policy and priorities in enforcement and advocacy

8. The ICA strives to base its enforcement as well as its advocacy activities upon clear policy objectives and well framed priorities. These policy objectives and priorities are reviewed periodically, taking into account the economic situation at a given time as well as available resources.

9. ICA's current policy objectives are to contribute to increased competition in the domestic sector and public services.

10. Comparison shows that the domestic sector in Iceland is lagging behind in terms of productivity when compared to neighbouring countries. In this respect the ICA has taken note of the recommendations put forward in the OECD Economic Surveys for Iceland, published in September 2015. In the report, the OECD encourages the authorities to set the course for productivity growth, i.e. through competition policy implementation. This is explained in the following manner: *"Despite the recovery [from the crisis], income per capita remains lower than in other Nordic countries and near the OECD average, reflecting weaker productivity. While Iceland has a business-friendly environment, it can be difficult for new firms to enter markets, thus deterring innovation. Due to the small size of the economy, ensuring competition can be a challenge."*

11. Based on its policy objectives, the ICA has prioritised important markets, such as the financial market, groceries and agriculture, construction, the public sector, as well as transportation, which is a sector that affects many areas of the domestic services sector.

12. As to the public sector, the ICA advocates for competition incentives being used to increase efficiency and quality in public services, without precluding equal access regardless of financial or social status. Many areas in the public sector, such as waste management, health care and education could benefit from competition.

13. With these objectives in mind, the ICA has maintained firm enforcement and endeavoured to broaden its advocacy role. Examples of this are described in chapter 2.

2. Key examples of enforcement and advocacy

2.1 Market investigation into the fossil fuel market

14. Fossil fuel is important for the Icelandic economy. For that reason, active competition in the fossil fuel market can have considerable and positive effects on the nation's economy and Iceland's competitiveness. Almost all transport vehicles use fossil fuels as a source of energy, as do important sectors such as the fishing industry. The significance of the market is of great importance to consumers, but Icelandic households spent approximately ISK 45 bn. on fuel in 2012. Fuel costs, moreover, comprise a major proportion of the expenses of many sectors.

15. In November 2015, the ICA published an in-depth report outlining preliminary findings of a market investigation into the fossil fuel market in Iceland. The report contains a detailed examination of circumstances and conduct in the market that may have harmful effect on competition, to the detriment of the public. The report also discusses what actions may be taken to counteract the circumstances or conduct

that harms competition. As the report contains preliminary findings, all conclusions and results contained therein may be subject to changes.

16. The preliminary report is part of a market investigation in which a position is taken on whether and, if so, which circumstances or conduct that harm competition are evident in the fossil fuel market. According to the Icelandic Competition Act, the ICA has powers to take action against any circumstances or conduct that restricts competition, even though violations of the competition law have not been identified. This market investigation regime is similar to that of the CMA in the UK.

17. The preliminary report identified the following circumstances and conduct that raised competition concerns:

1. *Vertical integration and entry barriers.* The report concludes that the companies that operate in all levels of the market have incentives and abilities to exclude new competitors by refusing to sell fuel on a wholesale basis or prevent their access to storage space. There are also indications that companies have taken advantage of storage space in certain areas to prevent the entrance of competitors.

2. *Coordination:* The report identifies strong indications of tacit collusion in the market for retail sales of vehicle fuel. Indications of such coordination can be seen in the fact that prices and mark-up on road fuel is quite high in comparison to that in other countries. Analyses indicate that the prices of road fuel tend to better follow increases in import prices than decreases and price changes appear to be led by certain entities in the road fuel market. Moreover, there are relatively little fluctuations in market share and mark-ups in the sale of road fuel, in comparison to fuel types sold only to companies. Road fuel prices appear to be extremely sticky and aspects, that should normally have an impact on market prices where competition is active, do not appear to significantly impact the road fuel market

3. *Regulatory framework and implementation by the authorities:* The distribution by Flutningsjöfnunarsjóður olíuvara (Transport Cost Equalisation Fund for Fossil Fuels) of detailed information about the fuel companies’ market share is likely to have an adverse effect on competition. The same applies to the opportunity of the companies to have some involvement with the Fund’s board. The framework and implementation of planning and land allocation for fuel stations is also likely to harm competition. The Planning Act does not ensure that account is taken of competition assessment in municipal planning and the allocation of land. In addition, Reykjavík City’s policies in its municipal zoning plans for the allocation of land for fuel stations are likely to have a detrimental effect on competition in the market.

18. According to the report, prices of road fuel (diesel and petrol) in Iceland are higher than in most other western countries, and the difference cannot be attributed to the size of the market or to the additional cost of selling fuel in Iceland. In addition, the mark-up of the fuel companies on road fuel is so high that it indicates that there is limited competition. When the profitability of the companies is compared with the estimated weighted average cost of capital (WACC), they cannot be seen to have systematically returned excess profits over the past decade. These results could be interpreted as undermining the likelihood of serious competition impediments or could be traced to misallocation of capital, as there are a great number of fuel stations in Iceland and their utilisation is poor in international comparison. Mark-ups on fuel sold to companies (major users), however, indicate that there is greater competition in that sector.

19. The report concludes that increased competition would release forces that would benefit the society, e.g. through the fuel companies' more economical operation which in turn would lead to lower prices for consumers. To bring this about, efforts should be made to ensure that new competitors are able

to enter the market. To that end, overseas experience has shown that independent fuel retailers (e.g. supermarkets) can provide integrated fuel companies with considerable competitive restraints.

20. The findings of the report are subject to changes, as they are preliminary findings. The report was published in order to give all interested parties the opportunity to give their opinions and add to the information that already has been gathered. Therefore, the ICA requested the reactions and opinions of everybody that are interested in the fuel market. Subsequently, ICA received detailed remarks, mainly from market participants.

21. In September 2016 the ICA organised a large conference, as a part of the investigation process, where the preliminary findings and the reactions to them were discussed by interested parties in panels. At the conference, the ICA showed Skype interviews with a few heads of agencies and academics in Europe and the US, facilitating an in-depth discussion on the issue.

22. Based on the extensive feedback and responses to the preliminary report, that have been gathered, the ICA is now taking a decision on whether the identified circumstances and conduct that raised competition concerns still exist and, if so, whether it is necessary to take action against the circumstances or conduct that disrupts competition to the detriment of public interest. The ICA intends to take a decision on possible further steps in the beginning of 2017.

23. The investigation is run in a transparent manner, as extensive information is available on the ICA's website.[1] A summary of the preliminary report is available in English.[2]

2.2 Common ownership in Iceland – Do we have a problem?

24. Moving out of the financial crisis, Icelandic markets have experienced increased level of common ownership. This has resulted in a market structure where competitors in many significant markets are owned by the same set of investors, each of the investors holding shares in more than one competitor in a given market.

25. To give an example, three largest owners of the two biggest telecommunications companies in Iceland are the same investors. Common ownership amounts to more than 60% of the total shares in each of the companies. As to the groceries market, 10-15 of the 20 largest owners of three big groceries companies in Iceland own shares in two or three of these companies. Common ownership amounts to more than 50% of the total shares in each of these three companies. Again, in the insurance market, 10-15 of the 20 largest shareholders of the three biggest insurance companies own shares in two or three of these companies, amounting to more than 45% of the total shares in each company.

26. The three biggest pension funds in Iceland are the biggest shareholders in most of the largest companies in Iceland with around 5-15% each in each company, i.e. 15-45% total in each company in many markets. To give an example, the four biggest pension funds hold around 20-40% of the shares of each of the three biggest insurance companies.

27. Recent papers [such as José Azar, Martin C. Schmalz & Isabel Tecu (2015); Azar, Raina & Schmalz (2016)] show empirically that an increased level of common ownership has led to higher prices in the U.S. airline and banking markets.

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1 http://www.samkeppni.is/samkeppnisreglur/markadsrannsokn/

2 http://en.samkeppni.is/media/skyrslur-2015/Summary_enska.pdf

28. Given the oligopolistic nature of the most significant markets in Iceland, the ICA is concerned about the increased level of common ownership and its effect on competition. In fact, the ICA has expressed its concerns on the issue as early as in 2012, when the pension funds had begun to increase their common shareholding.

29. In May 2016 the ICA invited a range of market-players, academics and the Minister of Finance and Economic Affairs to a conference on the issue. Subsequently, the ICA has continued discussions with stakeholders. Furthermore, the ICA has raised the issue at European level and initiated contacts with academics in the United States and the EU. The Authority intends to follow this issue closely and welcomes any input from other competition agencies, academics or other interested parties.

2.3 Competition restrictions in the dairy industry

30. In July 2016, the ICA imposed a 480 million ISK administrative fine on Mjólkursamsalan ehf. (MS Iceland Dairies), due to a serious abuse of a dominant position. According to the decision, MS abused its dominant position in the market by selling its competitors basic raw material for the production of dairy products at an abnormally high price, while at the same time, MS and associated parties were sold the same raw material at a much lower price, and, additionally, below cost of production.

31. This meant that MS and associated parties were given a significant market advantage over their competitors. In doing so, the ability of the competitors to compete with MS and associated companies was significantly reduced and the interests of consumers and farmers harmed.

32. Non-pasteurised milk (raw milk) is a basic raw material in the production of all forms of dairy products. The pricing of and access to such raw material, therefore, is extremely important for all companies that produce and sell dairy products. MS is the only company in Iceland that sells raw milk wholesale to other dairy goods producers, as well as using it for its own production.

33. MS is in a significantly strong position in the Icelandic dairy market and receives approximately 90% of the raw milk produced by farmers. In addition, MS is closely associated with the second largest company in the dairy market, Kaupfélag Skagfirðinga (KS). Together, these companies very nearly monopolise milk transactions in Iceland.

34. At the end of 2012, a small independent competitor, Mjólkurbúið, became aware that the company had to pay a considerably higher price for raw milk than its competitor, which is associated with MS. This came into light when MS, by mistake, sent an invoice to Mjólkurbúið, intended for its competitor.

35. An earlier decision on the case was taken already in 2014, where MS also was found to have abused its dominant position. The decision was appealed to the Competition Appeals Committee. The Appeals Committee overturned the ICA’s decision and asked for a re-examination of the case, as MS had submitted new information to the Appeals Committee which was not provided to the Authority when the case was first examined. The recent decision from July 2016 is the result of the re-examination, asked for by the Appeals Committee.

36. In the new decision the ICA finds that MS had provided the ICA with incorrect information and neglected to hand over important information in the first investigation of the case. The MS is fined for that negligence.

37. The new decision was appealed to the Competition Appeals Committee in August 2016. The ruling of the Appeals Committee was pending in mid-November.

2.4 Advocacy initiative – "Let's talk about competition"

38. Late 2015, the ICA started a special advocacy initiative through a series of meetings, held under the heading "Let's talk about competition". The following issues have been covered so far:

1. *Competition and the Public Sector – Competition Assessment (OECD):* In December 2015 Ania Thiemann, Head of Global Relations at the Competition Division of the OECD, was invited to Reykjavík for a conference held by the ICA on competition in the public sector. Ms Thiemann introduced the competition assessment projects run by the OECD in Greece and elsewhere and explained the methodology of the OECD Competition Assessment Toolkit. The conference was attended by a large group of key officials at ministerial level, from other areas in the public sector, from business associations and the academia. Ms Thiemann also held an in-house seminar for the staff of the ICA, explaining in more detail the competition assessment project. The conference was followed by additional initiatives on behalf of the ICA to introduce the competition assessment project.

2. *Competition in Agriculture:* The issue of competition in agriculture is rather controversial in Iceland, as competition rules have been set aside in important areas of the sector. The ICA has for many years argued that vigorous competition would serve the interests of farmers and consumers alike. It has issued a range of decisions and formal opinions on the issue. In February 2016, the ICA invited the Minister of Agriculture, together with key people covering the interests of farmers, producers, the groceries sector, other stakeholders and academia. The meeting was a very productive one, although limited progress has been achieved yet.

3. *Enforcing EEA Competition Rules in Iceland:* Iceland´s participation in the European Economic Area includes that the ICA enforces the prohibition rules (collusion and ban on abuse of a dominant position) of the EEA-agreement. This is done in close cooperation with the EFTA Surveillance Authority (ESA). ESA ensures that the investigations and decisions of the ICA provide for an effective implementation of the EEA-agreement. In February 2015, the ICA held an open conference on the enforcement of EEA competition rules in Iceland. Gjermund Mathiesen, Director of Competition and State Aid at ESA was the keynote speaker, explaining the key issues of effective implementation of the EEA-rules, such as the level of fines in the context of deterrence effects. The meeting was attended by over 100 people from various areas of the business community, academia and the public sector.

4. *Ownership of Undertakings – The Role of Pensions Funds and Competition:* In May 2016 the ICA invited a range of market-players, academics and the Minister of Finance and Economic Affairs to a conference, discussing common ownership in Iceland. A special point of discussion was the fact that the largest pension funds in Iceland hold shares in more than on competitor in several significant markets. Around 80 key people representing important stakeholders participated in the discussions. The conference was prepared with the assistance of Martin C. Schmalz, phd. University of Michigan, who has participated in extensive researches on the issue in the United States. A Skype interview with him on the issue is accessible on the ICA´s website. Common ownership is discussed in more detail in chapter 3.2.

2.5 Other key initiatives in 2015

39. In the annual report on competition policy in Iceland in 2014, DAF/COMP/AR(2015)39, a few issues are discussed that were concluded in 2015. For reminder, these can be mentioned:

1. *The payment market:* In 2015, the ICA concluded an extensive investigation into the payment market in Iceland. Each of the three largest banks in Iceland, together with the two largest payment card companies, had reached a settlement with the ICA at the end of 2014, admitting i.e. that the arrangement used for determining interchange fees violated the ban on collusion. The parties agreed to extensive measures aimed at removing competition hurdles, such as changes to the ownership of the payment card companies and steps to reduce interchange fees.

2. *The groceries market:* In March 2015, the ICA issued a report on competition in the groceries market. The report was partly a follow-up of a report from 2012, where considerable barriers to entry into the market were identified. The report identifies barriers to competition and compiles earlier recommendations and interpretations, concerning competition in the market and the conduct of companies. The compilation also addresses desirable changes in the agricultural sector, allowing for more competition.

3. *Hard ware stores:* In May 2015, the ICA concluded that Byko violated the Icelandic Competition Act and the EEA-Agreement with extensive collusion with Húsasmiðjan (hard ware stores). The ICA imposed a fine on the parent company of Byko. The decision concerning Byko was brought before the Competition Appeals Committee. In its ruling from September 2015, the Appeals Committee confirmed that Byko had violated the Competition Act but reduced the fines, as it found the violations not to be as serious as the ICA had concluded and that the EEA competition rules (namely Article 53 of the EEA Agreement) did not apply. In January 2016 the ICA decided to bring the ruling before the District Court for annulment and the case now awaits to be heard by the court. In April 2016 the EFTA Surveillance Authority (ESA) announced that it has submitted written observations ("*amicus curiae*" observations) to the District Court in the case as the case raises important questions regarding the correct application and interpretation of EEA law. The observations submitted by ESA concern the circumstances in which the EEA competition rules apply (i.e. when trade may be affected) and the importance of the appropriate level and deterrent effect of fines in competition cases.

4. *Slot allocation at Keflavik Airport:* Following extensive investigations and advocacy initiatives, the ICA issued a reasoned opinion directed to the Minister of the Interior and the Icelandic Transport Authority, concerning slot allocation at Keflavik Airport. Experience has shown that Icelandair has enjoyed a favourable position at the airport when new slots are opened, compared to other competitors. In ICA's reasoned opinion the authorities are asked to reconsider the slot allocation arrangements at the airport, taking into consideration the competition obstructions identified by the ICA. The ICA furthermore proposed that the authorities should base their revision on the approach provided for in the OECD Competition Assessment Toolkit. The opinion was issued on 22 October 2015.

40. For further details on these topics, see the annual report for 2014, DAF/COMP/AR(2015)39.

3. Resources of the Competition Authority

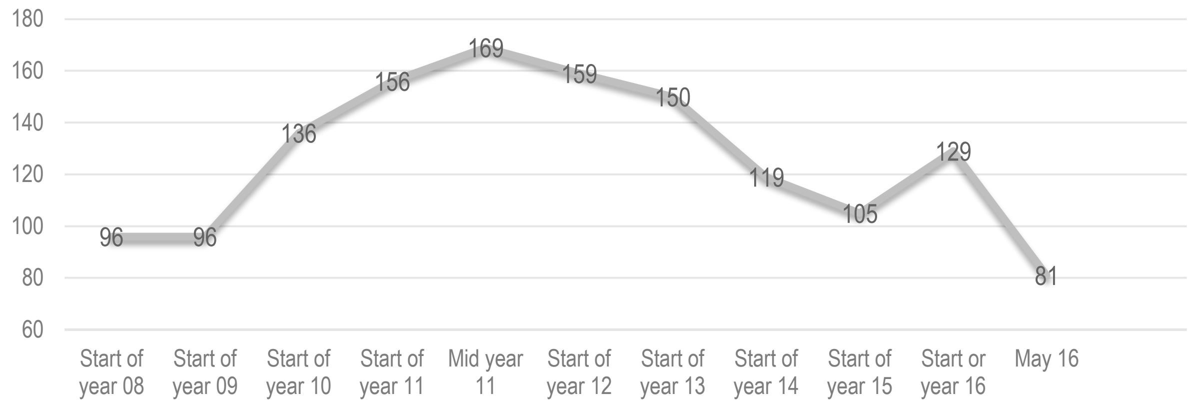
3.1 Budget and pending cases

41. The ICA is funded through the state budget. The budget for 2016 amounts to approx. 3,6 m. EUR.

42. Since the banking collapse in 2008, the ICA has had to apply rigorous prioritisation in response to increased pressure from business undertaking facing difficult competition impediments and at the same time budget cuts, resulting from the difficult budgetary situation of the state. As shown on figure 1, the

number of pending cases rose from around 100 to 170 from 2008 to 2011. By taking up more stringent prioritisation criteria, the ICA has managed to decrease the number of pending cases down to roughly 80.

Figure 1: Number of pending cases



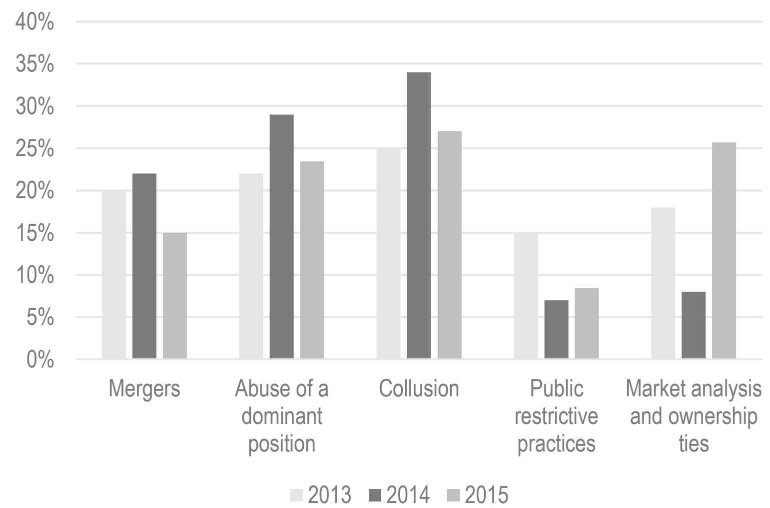
43. In parallel with the increase in a number of cases, the average case duration increased during the crises. By reducing the number of cases through tougher prioritisation, the ICA is working towards decreasing the average case duration.

3.2 Allocation of resources

44. The ICA keeps track of and manages the allocation of employee's work as regards various areas of responsibilities. The breakdown is based on time measurement.

45. As shown in figure 2, cases dealing with abuse of dominant positions are a significant part of the ICA's work. This can be explained by the fact that Iceland is a small economy, with oligopolistic markets in many areas.

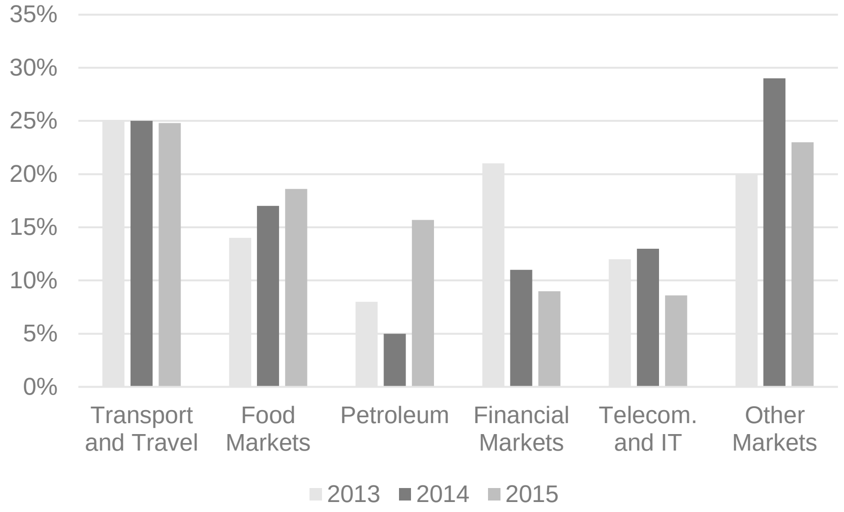
Figure 2: Allocation of resources – types of work



46. As shown in Figure 3, a considerable part of the ICA's time is allocated to transport, due to an extensive investigation into a possible collusion. It is also noteworthy that time allocated to the telecom

markets have decreased, as the ICA has already been able to remove some of the most damaging competition impediments in the field.

Figure 3: Allocation of resources - markets



47. At the end of the year 2015, 23 employees were working at the ICA.