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No smoke without fire? The *Tobacco* appeals

In 2010 the UK Office of Fair Trading fined two tobacco manufacturers and a number of major UK retailers for anti-competitive agreements relating to the retail prices of cigarettes. One manufacturer and five retailers appealed against the OFT's Decision. In December 2011 they won their case. What was the economic theory of harm at the heart of the case, and why did the Competition Appeal Tribunal rule against the OFT?

On December 12th 2011 the UK Competition Appeal Tribunal (CAT) issued its judgment in the *Tobacco* case.[1] This case involved appeals by five retailers, along with a major tobacco manufacturer (Imperial Tobacco Limited, ITL), against a Decision by the UK Office of Fair Trading (OFT) of April 15th 2010. The OFT ruled that there had been a breach by object of Chapter I of the Competition Act 1998 due to certain vertical agreements between the major tobacco retailers and the two largest UK tobacco manufacturers, ITL and Gallaher. The CAT judgment represented a victory for the appellants, as it quashed the OFT's Decision against all the appellants.[2]

The *Tobacco* case itself is an interesting one, as it deals with a number of points that are rarely considered in competition policy. These include the central issue of how vertical agreements could be harmful to consumers per se, and what factual evidence is required to support an economics-based competition case. Setting out the details of the OFT's case, we demonstrate how key flaws led to the case collapsing during the appeal.

Case timeline

The *Tobacco* case concerned vertical agreements between cigarette manufacturers and retailers in the UK. It originated from an investigation in 2003 into the behaviour of ITL in the cigarette paper market, during which UK supermarket, J Sainsbury plc, made a leniency application regarding the vertical agreements between tobacco retailers and manufacturers, admitting them to be in breach of competition law. After a five-year investigation, the OFT issued a statement of objections (SO) in April 2008,[3] alleging that the agreements led to unlawful restrictions on the pricing of tobacco products in the UK. In addition, the SO alleged that the agreements led to indirect exchange of future pricing intentions between both retailers and manufacturers, and their respective competitors. Both allegations were found to have the object and/or effect of preventing, restricting or distorting competition, and were therefore in breach of the Chapter I prohibition.

Following the SO, Gallaher and five retailers (Asda, Somerfield, First Quench, One Stop Stores and TM Retail) admitted breaching the Competition Act and reached early-resolution agreements with the OFT. This ultimately led to a reduction in their combined penalties from £173.3m to £132.3m. The OFT continued its investigations against ITL and the remaining retailers, all of which had declined early resolution.

In its April 2010 Decision,[4] the OFT found that between 2001 and 2003 Gallaher and ITL, which held a combined market share of around 90% during this period, had entered into bilateral agreements with ten retailers[5] that restricted the retailers' ability to set their retail prices for tobacco products independently. The OFT imposed a combined fine of £225m (including all early-resolution discounts) on ITL, Gallaher and the ten retailers. This represents the largest fine ever imposed by the OFT under the Competition Act 1998; ITL's fine of £112m being the second-largest ever imposed by the OFT on an individual company. J Sainsbury plc received complete immunity from fines under the OFT's leniency policy, and Tesco was not found to have breached competition law as there was insufficient evidence against it. The Decision was somewhat different from the earlier SO: there was no longer any claim that the agreements had anti-competitive effects, only that they had the object of restricting competition; and the allegations relating to the illegitimate exchange of pricing information were dropped.

ITL and the remaining retailers (The Co-operative Group, Morrisons, Shell and Asda, which withdrew from its early-resolution agreement) appealed the OFT Decision on the grounds that the agreements did not have an anti-competitive object, but instead were harmless or, indeed, pro-competitive.

In December 2011, after 26 days of hearings but well before the scheduled end of the case, the CAT allowed the appeal against the OFT Decision, after the factual evidence failed to support the OFT's economic case.

The form of the agreements

Much of the case focused on the precise form of the allegedly anti-competitive agreements between the retailers and manufacturers, as this was central to the factual elements of the case.

At the core of the agreements was that tobacco manufacturers and retailers engaged in relative pricing arrangements that paired brands of the two manufacturers that were considered to have similar characteristics—for example, Benson & Hedges (a Gallaher product) was paired with Embassy Number 1 (an ITL product). Almost every major brand in the tobacco market was paired. While retailers were free to price a brand pair at any *absolute* level, the agreements restricted their *relative* pricing. If these relative price restrictions were not adhered to, the manufacturer would be able to reduce the level of bonus paid to the retailer. For example, such an agreement might require the price of Benson & Hedges to be 3p above that of Embassy Number 1, but without specifying any particular price level—prices for the brands of 303p and 300p per packet would satisfy the agreements, as would prices of 353p and 350p. Adherence to the agreements was incentivised by the payment of small bonuses. Due to their nature of fixing relative shelf prices, these agreements are commonly referred to as 'parity and differential agreements' (P&Ds).

There was significant uncertainty throughout the case as to how P&Ds were implemented and the extent to which they were adhered to. Some of the agreements were not based on formal contracts but operated through a loose exchange of emails, while others were set out in various trading agreements. However, the exact form of the agreements was crucial to the case, which led to an extended debate between the parties about the nature and practical implementation of P&Ds.

The case was further complicated by the fact that the agreements in question were novel from a competition policy perspective, and both the theory of how they operated and practical experience in assessing such agreements were therefore limited. Most economists agree that vertical agreements are generally pro-competitive.[6] However, conclusions of this type do not readily extend to P&Ds, which are vertical agreements, but were claimed by the OFT to have a horizontal element (due to the link between the prices of competing brands). The OFT therefore required an in-depth economic assessment to determine what the effects of P&Ds were. In light of the object nature of the case, this economic analysis focused on the obvious and necessary consequences of the agreements for rational, profit-maximising firms. As will be shown below, the economic analysis demonstrated that the OFT's case was heavily dependent on the facts.

The OFT's understanding of the agreements: an economic analysis

The OFT's understanding of the agreements was that they required a fixed parity or differential between the retail prices of paired brands.[7] In other words, if two rival brands, A and B, were paired at parity, the retail price of brand A always had to be the same as the retail price of brand B.[8] A change in the underlying relative wholesale prices—eg, due to a unilateral wholesale price change by one of the manufacturers—would not, in the OFT's view, alter such a parity requirement, despite the change in the retailer's underlying cost structure. For example, if the manufacturer of product A raised its wholesale price by 3p, any change that the retailer wished to make to the retail price of brand A would also need to be made to the retail price of brand B. The OFT based its economic analysis on this understanding of the facts.

In the absence of any vertical agreements, when a cigarette manufacturer raises its wholesale price, it generally loses sales, for two, related, reasons:

- consumers face higher prices as retailers pass on the price increase, and so some consumers purchase fewer cigarettes in total;
- the manufacturer loses sales to rival products that have become relatively cheaper as a result of the price change; consumers may switch their demand to a different competing brand.

The same logic applies to wholesale price reductions, with manufacturers gaining demand for the same two reasons.

The OFT claimed that, on the basis of a standard theoretical economic framework, P&Ds would be expected to weaken both of these effects, reducing the loss in revenues for any wholesale price increase and increasing the loss in revenues for any wholesale price decrease. Without a P&D—that is, when the retailer is free to set its retail prices for competing products independently of one another—a wholesale price increase on one retail product will decrease the margin of this product relative to the margins that the retailer

earns on other products. The retailer therefore has an incentive to raise the price of this product in order to shift sales towards more profitable competing products (and restore its margins earned from consumers who continue to buy the more expensive product).

If, on the other hand, a retailer is subject to a P&D, it cannot raise the price of a product subject to a wholesale price increase (product A) without implementing the same price rise for the paired competing product (product B). Thus, if the retailer increases the price of product A by the amount that would be optimal in the absence of a P&D, it would be required to increase the price of product B by the same amount. This is not in the retailer's interest because, in the absence of a P&D, it would not have made this price change on product B. The retailer will therefore find it optimal to increase the retail price of product A by less (and increase the price of product B by more) than it would have done without a P&D.[9] It follows that this type of P&D would be expected to reduce the pass-through rate to retail prices of any wholesale price change. Figure 1 overleaf illustrates the impact of a P&D on the retailer's optimal pricing. As the retailer's demand for product A becomes less sensitive to changes in the wholesale price of the product, the manufacturer has an increased incentive to raise its price because it would lose fewer sales in doing so. Similarly, the manufacturer has a reduced incentive to lower the price, as its volumes would rise by less than they would without a P&D.

Furthermore, in the absence of this type of P&D, if a manufacturer increases its wholesale price, it loses sales as consumers switch their demand to competing products that have become relatively cheaper. This effect will be eliminated if the retailer is required to keep relative retail prices constant.[10] This further increases the manufacturer's incentive to raise its wholesale prices.

Due to a combination of these two factors, it was the OFT's assessment that wholesale prices would be expected to be higher as a result of the P&D. This leads to higher prices for consumers as higher wholesale prices are passed on by retailers (at least to some extent). The OFT therefore concluded that P&Ds were anti-competitive by object.[11]

The factual evidence and its implications

As has been set out above, the OFT's understanding of the agreements was that they required a fixed parity or differential to be adhered to, regardless of the wholesale prices set by the manufacturers. However, the appellants' view of the operation of the agreement was different. Their understanding was that a given set of parities or differentials had to be observed only while wholesale prices remained unchanged. When wholesale prices were changed, the appellants' understanding was that the desired parity or differential would be adjusted to be in line with the net change in wholesale price. As such, there was never a requirement to increase the retail price of a tobacco product that had not seen a change in its wholesale price.

Considerable analysis was undertaken by the appellants as to what the outcome of P&Ds would be under this alternative form of operation. It was shown that they would not have the impact of increasing prices—indeed, in the theoretical model adopted by the OFT, they would lead to lower wholesale prices, and therefore lower retail prices.[12] As such, they could not represent an object breach of the Competition Act, and, if the appellants' interpretation of P&Ds were proven, the OFT would have no effects-based analysis to fall back on, as any effects-based element of the case would have been dropped at the Decision stage.

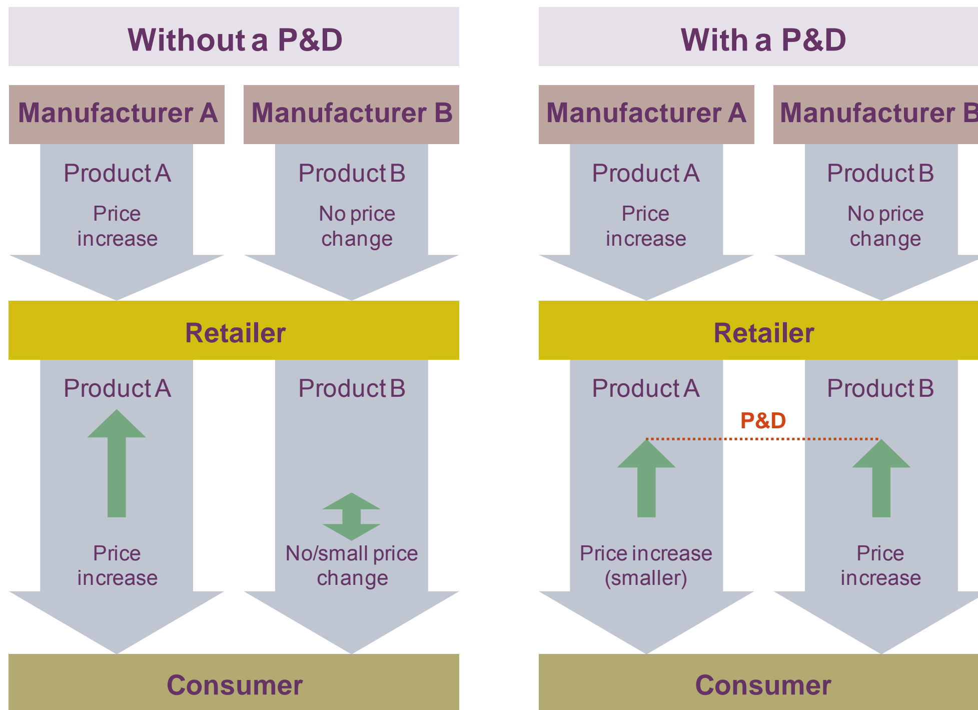
Unfortunately for the OFT's case, the factual witnesses called during the CAT proceedings unanimously supported the appellants' position. This included the OFT's own witness (a tobacco buyer from Sainsbury's) who had stated in the original Decision:[13]

> if, say, [ITL] had a [wholesale price increase] and they were the first one to go and they put Marlboro up 5p, I would not stick Benson & Hedges [which was paired with Marlboro] up 5p if Gallaher had not announced a price increase, even though [ITL]'s strategy was to have parity between Marlboro and Benson & Hedges. It was [ITL]'s decision to go first and they would expect somebody to follow them. They would not come to me and say 'Gallaher have not had a price increase but we expect you to increase all their shelf prices'.

As such, the OFT's position in the case became untenable, as it had relied on a set of facts for which there was no evidence. This was the key element in the CAT's quashing of the case. As the CAT said in its judgment:[14]

> at the point when the main hearing was adjourned there had been 19 witnesses who had come to the Tribunal to state on oath that the contemporary documents did not bear the meaning attributed to them by the OFT and that none of the [OFT's alleged] restraints formed part of the agreement between the manufacturer and the retailer. Conversely, there was no witness who said that the OFT was right in drawing the inferences it did from the contemporary documents. There was no sworn evidence before us either in written or

Figure 1 The OFT's theory of how P&Ds affect retail pricing



Source: Oxera.

oral form in which any witness said that he or she had entered into an agreement of the kind condemned by the Decision.

Conclusions

The *Tobacco* case was characterised by record fines and a seven-year investigation. Despite this, the OFT was successfully appealed by all parties that had not entered into leniency or early resolution—not on fines, but on whether they had, in fact, breached competition law.

While the OFT might be applauded for its development of a potentially well-founded theoretical economic case based on innovative thinking, such a case has merit only if it is founded on the underlying facts. It was this failure to link the economic analysis with a detailed factual examination of the market situation that eventually doomed the OFT's Decision. Furthermore, the case demonstrates the risks in pursuing a new form of object infringement without any evidence on harmful effects. Without such evidence, there is no reality check on any problems in the theoretical case, and there is no scope to fall back on the effects arising from an agreement if flaws are indeed found in the object case.

It remains to be seen what actions the OFT chooses to take next. In formal terms, the case is still active, and the OFT can issue a new Decision on the matter. Given the CAT's factual findings, however, it seems that the case would have to be considerably different from that which the OFT has defended for the last two years.

[1] Competition Appeal Tribunal (2010), '(1) Imperial Tobacco Group plc (2) Imperial Tobacco Limited v Office of Fair Trading', case number 1160/1/1/10.
[2] Oxera Director, Dr Helen Jenkins, was an expert witness for The Co-operative Group in these appeals.
[3] OFT (2008), 'OFT Issues Proposed Decision against Certain Tobacco Manufacturers and Retailers over Retail Price Practices', press release, April 25th.
[4] OFT (2010), 'OFT Imposes £225m Fine against Certain Tobacco Manufacturers and Retailers over Retail Pricing Practices', press release, April 16th.
[5] That is, Asda, The Co-operative Group, First Quench, Morrisons, Safeway, Sainsbury, Shell, Somerfield, T&S Stores, and TM Retail.
[6] The vertical relationship has the effect that participants engage in activities that are complementary to one another, which generally leads to a common interest in lower prices and higher quality. Under current US law, even resale price maintenance, which has historically been treated as a hardcore breach of competition law in both the USA and Europe, is no longer necessarily illegal. See http://www.supremecourt.gov/opinions/06pdf/06-480.pdf.
[7] In addition, the OFT considered a different specification of P&Ds that imposed a maximum on relative retail prices, rather than a fixed parity or differential. For example, such a P&D would require brand A to be priced no higher than 3p above brand B. This article assumes that P&Ds did not operate in this way, although this was one of the disputed facts of the case that was not settled.
[8] For simplicity of presentation, a parity agreement between two brands is considered here. The analysis is the same for a fixed differential, but instead of the agreement dictating that 'brand X must be the same price as brand Y', the agreement would dictate that (for example) 'brand X must be 3p per packet more expensive than brand Y'.
[9] The opposite applies for price reductions—given a cut in the wholesale price of product A, the retailer will find it optimal to cut the price of product A by less, and the price of product B by more, than it would have done in the absence of P&Ds.
[10] The magnitude of this effect depends on how many of the consumers that switch away from product A decide to switch to rival brands that are not paired with product A. The agreements generally paired the closest substitutes, which suggests that this effect played an important role.
[11] The OFT's theoretical framework described here is stylised and simplistic. It abstracts from a number of important characteristics of the real-world tobacco market. Most notably, it does not take into account non-price factors that supermarkets could use to favour one brand over another, such as promotional activity or shelf placement.
[12] Under the alternative interpretation of P&Ds, manufacturers have strong incentives to lower their wholesale prices because any wholesale price reduction leads to an equivalent change in the retail price differential, resulting in a significant price advantage to the price-reducing manufacturer. In the absence of a P&D, the retailer would be likely to absorb some of the wholesale price change as increased retailer margins, leading to smaller gains in volumes to the manufacturer.
[13] Office of Fair Trading (2010), 'Case CE/2596-03: Tobacco', April 15th, para 6.80.
[14] Competition Appeal Tribunal (2010), op. cit., para 86.

If you have any questions regarding the issues raised in this article, please contact the editor, Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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