

Another Fine Mess: OFT proposals pave the way to effects-based analysis of competition law penalties

1. "OFT's guidance as to the appropriate amount of a penalty", OFT423, September 2012. The guidelines relate to infringements that take place under both Chapter I (restrictive agreements) and Chapter II (abuse of dominance) of the UK Competition Act.

2. EU fines have certainly increased in recent years, though it is unclear whether that change was caused by the aggressive stance taken by Commissioner Kroes, or to the change in the penalties guidelines.

3. To achieve optimal deterrence levels, fines need to be at least as high as the expected private gains from cartel activity, and several times higher if the perceived risk of detection is low.

4. The claim that cartels elevate prices by 30% is most commonly justified by reference to the work of Connor, and the review conducted for DG COMP by Oxera concludes that the typical effect may be 20%.

5. Boyer and Kotchoni's "The Econometrics of cartel overcharge" criticises the Connor estimates on technical grounds. Rosati and Ehmer, "Science, myth and fines: Do cartels typically raise prices by 25%?" *Concurrences Competition Laws Journal*, No 4, 2009 also challenges the robustness of the Connor estimates.

6. See CAT Judgments on the Construction cartel (Kier et al) appeals of March and April 2011. The aggregate OFT fine was £129m across 103 separate cases, and the CAT reduced the fines in some of the other cases also.

7. CAT Judgment in the recruitment consultants cartel (Hays et al) of April 2011.

In September 2012 the OFT published new guidelines on penalties for competition law infringements.¹ The guidelines contain two main changes. First, they raise the starting point for calculating fines for "serious infringements" to 30% of relevant turnover (up from 10% in the previous guidelines). Second, they include a commitment to take "a step back" before applying mechanistic turnover-based rules for calculating fines, and to place greater emphasis on the need for proportionality. In this Brief we comment on the conflicting economic and policy issues raised by these changes.

The 30% starting point – treble damages?

The maximum fine allowed under the UK competition rules remains 10% of an infringer's global turnover, but the OFT's move from 10% to 30% of "relevant" turnover (essentially the turnover affected by the infringement) as the starting point for calculating fines for serious infringements aligns the UK Maxima with those in the EU penalties guidelines. This three-fold increase in the starting point is likely to increase fines, though evidence on the impact of the corresponding change in EU limits is mixed.²

The increase in the starting point for fines is driven by the OFT's belief that serious competition law infringements have very substantial effects on prices, and that the fines arising from application of the old guidelines could fall below the levels required for effective deterrence.³ Indeed, in recent years European competition authorities have espoused the view that serious cartel infringements on average lead to a 20-30% elevation in prices.⁴ If that result were robust, even the new OFT guidelines' approach would appear too timid to achieve effective deterrence. But the justification for such claims is contested,⁵ and assessing the effects of dominant firm conduct is even more contentious.

One obvious way to address this controversy would be for the enforcement authorities to generate a body of evidence on the economic impact of actual competition law infringements. However, the absence of any serious attempt by most agencies to assess economic effects (which itself arises from the absence of any requirement to do so under an "object" test) means that such potential insights on the likely scale of effects have to date remained substantially unexplored.

The commitment to "take a step back" – a move in the right direction

Whereas the trebling of the standard tariff for serious infringements clearly seems designed to increase fines, however, the new OFT guidelines' commitment to "take a step back" and give greater consideration to the proportionality of the fines that arise from the OFT's turnover-based formulae has the potential to push in the opposite direction.

This important change arises from two recent CAT Judgments in which, contradicting the prevailing belief that the old guidelines generated fines that were too low, OFT cartel fines based on the 10% starting point were substantially reduced on appeal. First, in a case involving alleged bid rigging in the construction industry, the CAT cut the fines on a key group of the infringing firms from £41.8m to just £4.4m.⁶ Second, in the cartel case involving recruitment consultants, the CAT's intervention led to a reduction in the OFT's original fine on the firms involved from £39m to less than £8m.⁷

8. See Article 464-2 of the Code de commerce. To determine the proportion of relevant turnover that is applied to calculate the basic amount of the fine, the FCA takes into account two factors: the gravity of the infringement and the damage to the economy caused by the infringement. The French Cour de cassation ruled that the extent of the damage cannot be presumed and must be assessed by the authority. Other jurisdictions, including South Africa, are also moving towards effects-based analysis.

9. See para 2.6 of the OFT guidelines. Para 2.20 also refers to the impact on competition as an input to the proportionality assessment.

The reasons for the reductions were very different in the two cases. In the construction industry case, the CAT was influenced by its assessment that the infringement was likely to have “limited adverse effects”. Specifically, the CAT found sympathy with the appellants’ argument that the conduct fell well short of the classic bid rigging behaviour in which seller coordination is likely to have a serious impact on procurement costs. Under so-called “cover pricing”, firms that had already decided they did not want to bid for a contract for legitimate commercial reasons, but wished to remain in contention for future projects, achieved this objective by contacting the active bidders to obtain information on their prices.

In the recruitment agency cartel case, however, there was no disagreement between the OFT and CAT on the seriousness of the cartel infringement as such. Instead, the CAT objected to the way in which the mechanistic application of the OFT’s turnover-based criteria led to an unrealistic fine level. The OFT followed its standard practice of applying a fines calculation based on a percentage of the gross turnover of the cartel members as declared in their financial results. But through an apparent accounting quirk this turnover figure happened to include the salaries of the employees that the agencies placed, as well as the fees they earned for providing their service. The CAT was concerned about the arbitrary influence of this accounting convention. In justifying its decision to cut the OFT fine, it concluded that the use of an alternative turnover measure based on a value-added element comprising solely the fees charged by the recruitment agency would provide a “more meaningful” basis for the fines.

Because of the formalistic way in which fines are calculated under the Competition Act, the legal arguments between the parties before the CAT on these cases, of necessity, focused on the way in which the various turnover-based tests were applied and adjusted. But taking both of these cases in the round it is hard to escape the conclusion that the disagreement between the parties on how to calculate turnover-based fines was in reality a proxy for a more substantive debate on whether, given the circumstances of the industries and infringements involved, the application of mechanistic turnover based rules led to sensible outcomes that reflected the likely economic impact of the infringements.

In an effects-based regime, this proxy debate about turnover rules and adjustments would be discarded in favour of a real substantive assessment of the likely economic effect of the conduct in question. Interestingly, this is a challenge that has been identified and addressed in the context of French domestic cartel cases, where competition law and Court judgments require the Autorité to assess explicitly the damage to the economy arising from the infringement.⁸ In contrast, the new OFT guidelines seek to retain turnover based rules as the main basis for fines, suggesting (unconvincingly) that any adjustments to ensure that the results generated by such rules are proportionate will be exceptional. They do, however, concede that “The damage caused to customers... will also be an important consideration”.⁹

The frequently voiced objection to adopting the French model of basing fines on actual cartel effects is the danger that this would prolong cartel investigations and mire the enforcement authority in expensive debate on the economics. But since the fundamental deterrence rationale for imposing fines is based on the adverse economic effects of anticompetitive conduct there is an element of unreality about this position.

Further, since two prominent CAT Judgments have recently demonstrated the potential for appellants to secure as much as a 90% reduction on the fines that arise from applying the OFT’s formulae, even under the old (10%) approach, there is also an obvious practical objection to resisting the role of economics.

10. In abuse of dominance cases, an explicit description of the adverse impact of the abuse on market outcomes (as opposed to competitors) would also help to build a better effects-based foundation to enforcement decisions.

11. In the EU Bananas Article 101 case, for example – see RBB Brief 31 – the Commission conceded that its theory of harm linked to information exchange on planned volumes fell apart in the context of a market in which quantity limits were imposed by the Commission’s own trade policy quotas, and consequently dropped that part of its case. An effects assessment would have brought that conclusion into sharper focus far sooner, and might well undermine more speculative theories of harm in other information exchange cases too.

12. See “Private Actions in Competition Law: A Consultation on Options for Reform”, BIS, April 2012. RBB’s commentary on the BIS consultation is available at <http://www.rbbecon.com/publications/cartels.html>.

13. See section 6 of the BIS consultation.

Future appellants might fail to replicate the success of these appellants, but they will surely try to do so through introducing substantive analysis to show that the turnover rules fail to capture either the nature of the infringement (as in the cover pricing case) or the realistic scope for cartel effects (as in the recruitment consultants case). Indeed, the new OFT guidelines have (unavoidably, in view of the CAT Judgments) opened the door to such arguments through their greater emphasis on the proportionality assessment. Hence, the only real choice is whether the debate on economic effects is introduced in explicit or implicit form.

One key advantage of committing to an explicit assessment of likely economic effects when setting fines would be that in many cases such considerations can also throw useful light on the likelihood that certain forms of conduct would actually harm consumers. In an information exchange case, for example, requiring the OFT to articulate how the conduct would feed in to a recognised theory of collusion (on prices, output levels or capacity) would provide a useful sense check to either eliminate or confirm *prima facie* concerns about the capacity of such conduct to cause harm.¹⁰

Of course, even if this assessment found that the conduct had little adverse effect on consumers, that should not necessarily preclude the imposition of a fine. Since the primary policy objective of administrative fines is to deter anti-competitive conduct, there is no contradiction in levying a substantial fine against an incompetently implemented cartel conspiracy that might have caused consumer harm. But if the theory of harm on which coordination concerns depend fails so badly that it would be inherently incapable of causing such harm, this would provide a useful pointer to suggest that the theory itself is flawed, and the conduct should not be seen as an infringement.¹¹ There is no good reason why competition authorities should be sheltered from this important discipline on their conduct in pursuing infringement decisions.

Linking fines with private actions for compensation

Finally, it is useful to consider how an assessment of economic effects might impinge on the follow-on damages claims that increasingly accompany competition authority decisions. The new OFT guidelines make no reference to private actions, just as the recent UK Government consultation on private actions showed little inclination to relate its discussion to the setting of fines, but a policy designed to optimise the deterrent to engage in anti-competitive conduct could build a useful bridge between these two elements.¹²

There are obvious synergies between fines and damages. At a minimum, explicit consideration of effects in OFT decisions would greatly improve the factual background on which follow-on damages claims are brought, in contrast to the current situation in which infringement decisions running to hundreds of pages typically reveal no insights as to the compensation that might be due to claimants.

Looking further ahead, introducing a more effects-based test on fines would also highlight the logic of moves to involve the OFT in efforts to secure compensation settlements from damages claimants, or even to use some of the proceeds of fines to provide the funds for such compensation payments.¹³ These ideas are mentioned in passing (but not recommended) in the UK consultation on damages, and are very unlikely to be workable for as long as the OFT’s role on penalties remains disconnected from substantive effects.

Conclusions

The new OFT guidelines on fines reflect an uneasy balancing act between the OFT's belief that fines under the old guidelines were too low, and the need for the OFT to respond to conflicting feedback received from the CAT that such fines could be far too high. It is perhaps unsurprising then that the new guidelines do not provide a clear message on the way ahead, but two clear themes emerge within this complex policy debate.

First, it is evident that basing fines on mechanistic turnover-based rules is inherently unsatisfactory, due both to the excessively broad class of conduct that is deemed to fit the category of so-called "serious" competition law infringements, and to the fact that even for genuine horizontal cartel conduct differences between industries provide a very poor link between turnover and anticipated cartel profits. As a result, approaches to fines based on such an arbitrary base will never derive results that are truly fit for the stated purpose of providing appropriate levels of deterrence to cartel activity.

Second, a greater focus on the economic effect of the conduct in question is the obvious tool to employ in attempts to correct for these inherent deficiencies in turnover-based fine calculations. The OFT guidelines have chosen to resist this inevitability by a somewhat imprecise commitment towards notions of proportionality, but as parties struggle with how to interpret this concept under the new guidelines they will increasingly be confronted by the question "proportionate to what?" The answer to that question is bound to involve some assessment of likely economic effects.

We would have preferred the OFT to have gone straight to the likely end game here by recognising, as French law has done, that fines ought to be linked directly to a measure of economic effects. But, largely thanks to the recent interventions of the CAT, the new guidelines will not allow the OFT to use its enhanced ability to raise infringement fines without in some form addressing economic effects. The enforcement of UK competition law should be stronger for this change, and the implications for related areas such as follow-on damages should in the long term make for a more coherent enforcement policy on serious cartel infringements.