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The OFT Tobacco Investigation: a case of smoke without fire

On 12 December 2011, after halting proceedings midway through the Appeal Hearings, the UK Competition Appeals Tribunal ('CAT') issued a Judgment that quashed the OFT's Competition Act Decision against trading agreements in the tobacco sector.[1] In the process, it annulled the record fines that had been imposed against Imperial Tobacco and the retailers that were appealing the Decision.[2] In this Brief we assess the factors that led the OFT's case to collapse and consider the wider implications for the assessment of vertical restraints.

Background to the OFT investigation

In the UK tobacco market two major manufacturers (Imperial Tobacco and Gallaher) have a combined share of around 90%. Both sell through a large and varied group of retailers that range from major supermarkets to individual corner shops and bars.[3] Each manufacturer owns a number of brands in each product category, with brands belonging to different 'tiers'.[4]

The OFT opened its investigation into the tobacco sector trading agreements in 2003. It produced a Statement of Objections ('SO') in 2007, and an Infringement Decision in 2010.[5] The case centred on so-called Parity & Differential ('P&D') agreements, whereby a manufacturer paid incentives to encourage certain retailers to set the retail price of its individual brands at a level 'no higher than' the retail price of a rival's directly competing product.[6] These P&D agreements covered less than one third of UK retail tobacco sales. They did not cover sales made through the many small retailers and bars, or sales to Tesco, the leading UK supermarket retailer.

Excise duty and VAT constitutes some 80% of the final retail price of tobacco products and regulations governing packaging and advertising mean that there is very little scope for manufacturers to communicate with consumers or to compete on parameters other than price.[7] UK tax regulations also require tobacco manufacturers to publish Recommended Retail Prices.[8]

Within this environment, manufacturers placed a high priority on ensuring that the retail prices of their products were competitive relative to those of their rivals. They therefore adopted P&D agreements to encourage retailers to set relative prices that would not disadvantage their brands in the store. In its evidence to the CAT, Imperial explained how the P&Ds had been introduced following frustration that retailers sometimes had not passed through wholesale price cuts in lower retail prices for its brands relative to the retailer's price for rival brands.

The OFT's theory of harm

The OFT's case went through a number of revisions between the SO and the Decision, but the core theory of harm was that the P&Ds were used as a device to aid inter-brand collusion between the manufacturers. The OFT held that this mechanism was sufficiently direct that they were anti-competitive 'by object'.[9]

If manufacturer A increased the wholesale price of its brand, the OFT noted that the retailer would probably increase the retail price of brand A. Crucially, the OFT alleged that in order to maintain the price parity condition within the P&D agreement with manufacturer A the retailer would then need to increase the retail price of manufacturer B's brand as well. Manufacturer B would then observe the higher retail price of its products and increase its wholesale price. Hence, the P&D incentives would have caused the retailer to coordinate an upward revision in the prices of the two competing brands.

1
CAT Judgment, Imperial Tobacco Group plc and others v OFT, 12 December 2011, [2011] CAT 41.

2
RBB Economics advised Imperial Tobacco, the leading UK manufacturer, throughout the OFT investigation and the CAT appeal. In total, the OFT had imposed fines in excess of £220m against the firms involved, including £112m against Imperial.

3
There are some, smaller, manufacturers present in the UK tobacco industry including BAT and Philip Morris, but these firms had a collective share of cigarette volume sales of only 10%.

4
For example, Imperial's *Richmond* brand competed against Gallaher's Dorchester brand in the budget price tier. Cigarettes are by far the highest-selling segment of tobacco products, though the sector also includes cigars and other products.

5
Imperial Tobacco contested the OFT Decision, whereas Gallaher agreed a settlement deal with the OFT. Asda, Morrisons, Co-op, Safeway and Shell were the retailers who joined Imperial in the appeal before the CAT.

6
In some cases the incentive payment was made if the retailer's price for the manufacturer's brand was 'no more than 3p above' or 'at least 5p below' the rival's product, but in all cases the agreements specified a relative retail price criterion. The incentives were paid either as a lump sum or as an effective per-pack discount.

7
As a result, retailer margins on selling tobacco products comprise an unusually low proportion of the price paid by the consumer, and this curtails the retailer's ability to flex its margin to achieve a significant price reduction.

In the case of a wholesale price reduction by manufacturer A, the OFT contended that the P&D agreements would cause the retailer to react by reducing the retail prices of brands A and B. But since that would negate any gain in retail price competitiveness that manufacturer A might have hoped to achieve from its initiative, the OFT concluded that such a P&D would 'give rise to significant incentives for both manufacturers to raise their wholesale prices, and significant disincentives for them to lower their wholesale prices.' [10]

The OFT reasoned that a horizontal agreement in which competing suppliers agreed to implement a rigid horizontal linking of their prices would obviously be anti-competitive, since that rigid link would encourage them both to increase prices, and discourage either of them from cutting price. By extension, it then argued that a series of vertical agreements in which the two main competing manufacturers both enlisted the retailer to implement the same kind of price linking would have a similarly anticompetitive impact.[11]

The OFT hired Professor Greg Shaffer, a leading industrial organisation theorist, to construct an economic model of the OFT's interpretation of the P&Ds on the assumption that they operated in this rigid manner. His report supported the OFT's position, concluding that such agreements would be anticompetitive 'from the moment they were established', and that this would remain true across a number of variations regarding the precise operation and coverage of the P&D agreements.[12]

Imperial's defence

Throughout the OFT investigation and the Appeal, Imperial and the retailers who joined with it in contesting the Decision maintained that the OFT had misinterpreted how the P&Ds operated. They denied that the P&Ds contained any requirement for retailers to increase or decrease the retail prices of the two competing brands together in the event that either manufacturer implemented a unilateral change in its wholesale price. Instead, the Appellants contended that the retail price differentials specified in the P&D schedules automatically adjusted when any such unilateral wholesale price change occurred, and hence that the P&Ds did not encourage retailers to move both brands' prices together.[13]

The Appellants argued that under this alternative characterisation of P&Ds the OFT's proposed theory of harm falls away. Several of the Appellants' economic experts showed that re-running Professor Shaffer's theoretical model under this alternative assumption of how the P&Ds operated turned the anti-competitive predictions of that model on their head. Instead of being an instrument to ensure coordination of inter-brand pricing, their version of the model showed that the P&Ds tended to encourage retailers to reflect any unilateral wholesale price changes in retail price adjustments. As a result, each manufacturer would gain a greater competitive advantage from any unilateral reduction in price, and would suffer a higher penalty for any unilateral decision to raise price. In short, the Appellants' version depicted P&Ds as a device to increase pass-through and hence to intensify inter-brand price competition.

Testing between the alternative views on P&D operation

Since the agreements themselves did not explicitly describe how the P&Ds operated in the event of a unilateral price change, they did not reveal which of these alternative characterisations best described the P&Ds. The Appellants' economists therefore explored a range of empirical measures and theoretical arguments to try to resolve this key issue.

With respect to empirical analysis, this work ranged from detailed micro-level descriptions of successful price promotions implemented by the manufacturers, to evidence showing the low levels of retailer adherence to the P&D criteria, and classic 'during and after comparisons' showing no evidence that manufacturers or retailer margins were boosted by the P&Ds during the period in which they operated. None of these analyses appeared to shake the OFT's faith in its theory of harm, however.[14] Even where the OFT acknowledged the empirical results, the Appellants' interpretation was rejected on the grounds that

8
To ease tax administration, the published RRPs (rather than actual selling prices) are then used to calculate the tax that has to be paid for each packet of cigarettes sold. However, there remains substantial discounting from list prices at an individual retailer level.

9
The OFT theory of harm is described (somewhat unclearly) in paragraph 6.216 of the Decision.

10
See paragraph 6.222 of the Decision.

11
See CAT Judgment, para 53.

12
The OFT also hired an expert from a leading economic consulting firm to analyse empirical evidence presented by the parties.

13
For example, if manufacturer A had a P&D that required the retail price of brand A to be 'no higher than' B, and then it increased the wholesale price of brand A unilaterally by 5p, the P&D would alter so that the retailer would now be required to set the retail price of brand A 'no more than 5p higher than' brand B. Hence, under this characterisation the P&D incentives were intended simply to influence the retailer's relative margins for the competing brands.

14
The OFT 2007 SO did contain a short section purporting to show the effects of the P&Ds, but in light of the strong criticisms made by the Appellants to this analysis, any effects considerations were abandoned in the final Decision and dismissed by the OFT throughout the CAT appeal.

showing an object infringement does not always meet its anti-competitive aims does not absolve it from illegality.[15]

At a more conceptual level, the Appellants' criticism of the OFT theory (and Professor Shaffer's model) focused heavily on the vertical nature of the agreements, and questioned the parties' incentives to engage in coordination of the kind alleged by the OFT. A vertical theory of harm needs to explain why the retailer would assist in inter-brand coordination when the resulting increase in wholesale prices would clearly be detrimental to its interests.[16] This challenge gains even more resonance when one considers that the retailers who participated in the alleged conspiracy accounted for only a small share of UK tobacco sales. In particular the OFT's theory that grocery retailers such as Asda, Morrisons and Sainsbury would engage in conduct that encouraged higher wholesale prices when their biggest rival, Tesco, did not, strained the credibility of the OFT's theory of harm beyond any reasonable limit.

The OFT's answer to this challenge was to assert that if the overall profits available from manufacturer collusion were sufficiently high, they would fund sufficiently high incentives to pay off the retailers for their role in making it happen. But that assertion was made without any reference to the actual size of P&D incentive payments. When, in turn, evidence on the comparatively small value of these payments was presented, the OFT and its economic experts simply referred to the *possibility* of other, undefined, mechanisms that might have been used by manufacturers to provide retailers with the necessary compensation, without specifying how or where these payments might have arisen in practice.

The CAT Hearing, the demise of the OFT theory of harm and the 'refined' theory of harm

The cross-examination of the economic experts in the CAT Hearings would have tested these areas of disagreement in greater detail. However, the CAT Hearing never got to hear the economic evidence. Instead, the OFT's case self-destructed after five weeks of oral cross-examination of the witnesses of fact – the tobacco buyers and sales executives who operated the P&D agreements in the field. They consistently confirmed that the characterisation of the P&Ds found in the Decision and assumed in Professor Shaffer's model was simply incorrect.[17]

Specifically, the factual witnesses consistently refuted the notion that the P&Ds obliged the retailer to adjust the retail prices of both competing brands if just one manufacturer changed its wholesale price. This discredited the notion that the retailer played the key role in coordinating inter-brand price competition. Since the core OFT theory of harm and Professor Shaffer's theoretical model had been based on this proposition, the CAT understandably halted proceedings and asked the OFT to clarify how its Decision could survive this seemingly fatal blow to its central premise.

The OFT's reaction was to present a so-called 'refined' case based on a new theory of harm, adapted to fit the facts that had emerged. Now, instead of claiming that the P&Ds were anti-competitive because they *prevented* the pass-through of unilateral wholesale price changes into retail price differentials, the OFT argued that the problem with the P&Ds was their tendency to *accentuate* the pass-through of wholesale price changes and therefore to increase the risk of inter-brand price coordination because of the resulting increase in retail price transparency.[18]

It is almost inconceivable that any such theory would meet the criteria for an object infringement, but an allegation that increased price transparency might have the effect of facilitating inter-brand collusion cannot be dismissed *a priori*. The CAT made no substantive assessment of the OFT's revised theory of harm, but it did firmly decide that it was not open to the OFT to perform such a U-turn mid way through the Hearing on a case that it had taken 7 years to prepare.[19]

15
A significant degree of agreement was reached on the empirical evidence through the meetings between the relevant experts prior to the CAT Hearing, but the OFT's strategy of segregating the empirical analysis from any consideration of the theory of harm, along with its reliance on the 'object' infringement claim to insulate the theory of harm from exposure to empirical testing, prevented such results from impinging on the OFT's belief in its case.

16
The fact that retailers are typically adversely affected by successful coordination between manufacturers makes agreements involving retailers and manufacturers inherently less likely to have an anticompetitive explanation.

17
Indeed, the factual witness for Sainsbury, the OFT's whistleblower and leniency applicant in the case, was among the most credible and forceful in explaining that the Decision had got its basic facts wrong.

18
Since Airtours/First Choice (Case M.1524), one of the essential conditions for a finding of collusion has been that the participants in any alleged collusive agreement must be able to observe their fellow colluders' prices. In other words, there must be pricing transparency.

19
The CAT reminded the OFT of its own claim, made previously in response to the Appellants' arguments that the P&Ds aided pass-through, that to contemplate different kinds of agreement than those originally claimed in the Decision would be 'self-evidently an irrelevant distraction.' See paras 54–55 of the CAT Judgment.

Lessons and conclusions

The outcome of the tobacco investigation carries a number of stark lessons for the OFT, and, more generally, for competition authorities that look to pursue complex theories of harm arising from vertical agreements.

First, when economists (and, increasingly, competition authority guidelines) state that the economic incentives underlying vertical and horizontal agreements are very different in nature, this principle has real and tangible consequences.[20] Throughout the investigation, the OFT at best paid lip service to this vital distinction, and in the process it ignored or evaded several checks that should have enabled it to take a more critical and robust approach to assessing its theory of harm. At a time when even resale price maintenance is increasingly recognised as justifying an effects-based approach to enforcement, it was somewhat reckless for the OFT to pursue a highly complex and untested theory of harm against a vertical agreement that on its face was clearly designed by the manufacturers to provide retailers with incentives that would help them to gain competitive advantage.[21]

Second, it is dangerous to rely on economic theory alone without reference to the empirical evidence. This key principle is embodied in the EU Commission's best practices Guidelines on economic evidence which states:

> 'whenever feasible, an economic model should be accompanied by an appropriate empirical model – i.e. a model which is capable of testing the relevant hypotheses given the data available'.[22]

Yet the OFT chose to advance a theory of harm on the basis of an abstract theoretical model that made no attempt to connect to the extensive industry evidence that the OFT had itself collected. Its approach of hiring one economic expert to examine solely theoretical issues and another, separate, expert to focus on empirical evidence might have been designed to evade rather than to embrace this basic best practice principle.

Third, the outcome shows that it is not tenable for an authority to use the banner of an 'object' infringement to escape responsibility for presenting a cohesive theory of harm that is consistent with observed facts. An object theory of harm should be so obvious that the facts speak for themselves. Given the current state of economic thinking on vertical restraints, it must be doubted whether any vertical restraint truly justifies being placed in the 'object' box, and certainly the OFT's theory of harm (in both its original and refined forms) fell a long way short of meeting any such test.

Economic theory played a key role in identifying how the evidence on the operation of the P&Ds contradicted the OFT's theory of harm, and in exposing the erroneous nature of that theory in light of the evidence. Ultimately, however, the OFT's case fell apart when the plain facts regarding the operation of the P&Ds were exposed during the CAT Hearing. The OFT lost the case on these facts, and showed poor judgment in pursuing a theory of harm through such a high profile and lengthy process without having conducted the necessary checks that the facts supported the theory.

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See, for example, paragraph 6 of the European Commission's 'Guidelines on Vertical Restraints'.

21
See the 2007 US Supreme Court Judgment in *Leegin Creative Leather Products, Inc. V. PSKS, Inc.*, in which the per se prohibition of RPM was rejected in favour of a rule of reason approach.

22
See DG Comp best practice guidelines, 2010, para 13. http://ec.europa.eu/competition/consultations/2010_best_practices/best_practice_submissions.pdf