

The Authority's Curious Proposal for a Declaration on LPG.¹

Introduction.

Some weeks ago, the Competition Authority announced that it was considering issuing a Declaration on exclusive dealer/supply agreements in the cylinder LPG sector. The effect of such a declaration would be to permit such agreements even though they may be contrary to the prohibition on anti-competitive arrangements in section 4(1) of the Competition Act, 2002. The Authority's announcement raises a number of important issues particularly in respect of procedures. It also raises some important analytical questions about market definition and the effects of vertical restraints.

Under section 4(3) of the Competition Act, 2002, the Authority may declare in writing that, in its opinion, a specified category of agreements, decisions or concerted practices complies with the requirements of section 4(5) of the Act. This requires that the category of agreement, decision, or concerted practice, having regard to all relevant market conditions, contributes to improving the production or distribution of goods or provision of services or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit and does not-

- (a) impose on the undertakings concerned terms which are not indispensable to the attainment of those objectives, and
- (b) afford undertakings the possibility of eliminating competition in respect of a substantial part of the products or services in question.

The Authority's announcement notes that a category licence granted in respect of such agreements under the previous legislation had expired on 31st October 1999. It states that subsequent to this three exclusive dealer/supply agreements were notified to it. The 2002 Act abolished the system for notifying agreements in order to request a certificate or licence. The Authority's announcement states that it was in the process of analysing these notifications when the 2002 Act 'came into force, which precluded the Authority from

¹ Compecon made a submission to the Authority on behalf of a client opposing the making of a declaration in respect of cylinder LPG.

coming to a decision on the notifications.’ It is therefore unclear why the Authority has referred to notifications made under the old Act.

Procedural Issues.

A Declaration is in many respects the equivalent of a category licence under the old legislation. The Authority’s announcement is silent as to the procedures it intends to follow in making such a Declaration. When granting a category licence under the former legislation the Authority’s practice was to produce a draft decision setting out the facts on which it was based, outlining the reasons for its proposals and inviting submissions on them. The High Court upheld this approach in judicial review proceedings in *Cronin v Competition Authority* and this judgment was subsequently endorsed on appeal by the Supreme Court. In his High Court judgment Mr. Justice Costello noted that:

‘The draft is a very detailed appraisal by the Competition Authority of the operation of the Act, and of the existing contracts Texaco had with retailers and of proposals for new agreements which might be entered into. The Authority then indicated its view of whether a licence should issue, the economic grounds, and the proposed form of the category licence...Persons interested...including Mr. Cronin, would see the view the Authority had taken of submissions made to it.’

In announcing that it is considering making a declaration for cylinder LPG, the Authority has not published any draft outlining its proposals. This is all the more surprising given its statement that it had been analysing notified exclusive dealing agreements for cylinder LPG that had been notified in 1999 prior to the coming into force of the 2002 Act. While the Authority’s announcement invites submissions from parties, it provides no information on which parties might base their submissions. It may well be that the Authority proposes to adopt an approach similar to that used when granting category licences in the past and that it will publish a draft setting out its proposals in due course. Why not do so at the outset if that is its intention?

The Authority’s notice contains no background information on the market or on the notified agreements. Instead, it states that:

‘It would be helpful if these submissions covered *inter alia* the following questions;

- Would a Declaration in this sector provide benefits to the industry, or should this sector be covered by the general rules that cover vertical agreements?
- Is cylinder LPG a properly defined relevant market from the perspective of competition law?’

It seems rather strange for the Authority to ask whether a declaration would provide benefits to the industry as this does not appear to be one of the criteria set out in section 4(5) of the Act.

The announcement then states that, if cylinder LPG were to be taken as the relevant market, parties should give their views on whether exclusivity delivers ‘benefits to consumers that outweigh the costs of the inherent restriction on competition’. It also states that if exclusivity were found to be warranted, the Authority would welcome views on how such exclusivity should persist and goes on:

‘Please feel free to bring to the Authority’s attention examples of how cylinder LPG is treated elsewhere, particularly in the EU.’

The Relevant Market.

The Authority has indicated elsewhere, most notably in its draft guidelines on analysing mergers, its intention to apply the SSNIP test for defining relevant markets. The SSNIP test identifies the smallest possible product and geographical market and asks whether a hypothetical monopolist in respect of such products and area could impose a small significant non-transitory increase in price. To answer this question, it is necessary to ask whether it would be profitable for a monopolist to do so. If enough consumers would switch to alternative products such a price increase would not be profitable and so the market would need to be expanded to include the closest substitute product and/or area. This process has to be repeated until the stage is reached where such a price increase would prove profitable, and the relevant market includes all those products and the

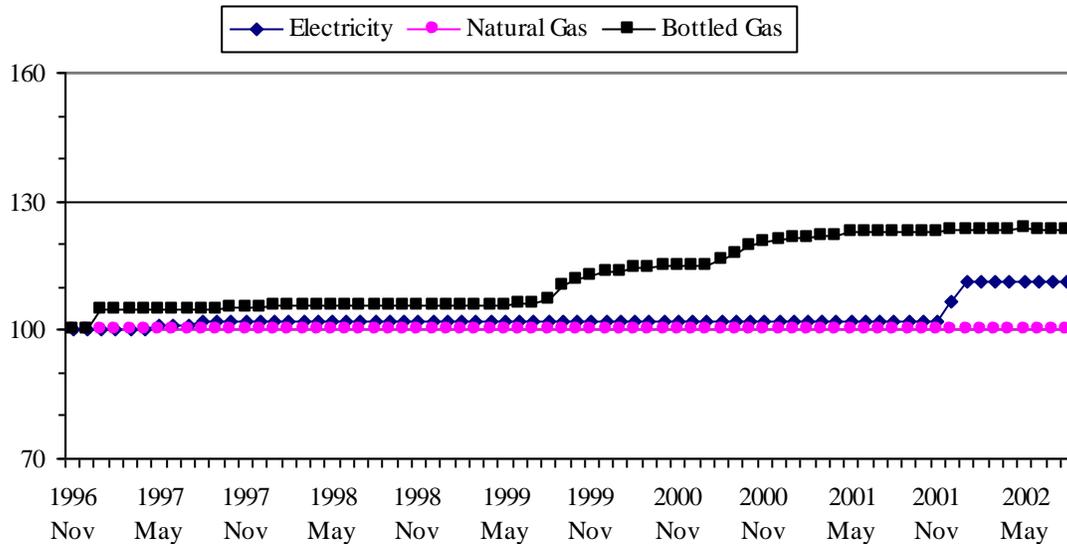
geographic area necessary for this to happen. Normally a price increase of 5% which is sustainable for one year is used in applying the test.

The point is that the SSNIP test is an objective test which is based on relevant market data. A useful indicator of whether cylinder LPG constitutes a separate product market is provided by looking at the past behaviour of prices of cylinder LPG and other potentially competing fuels. Such information is readily available from the CSO. In this case the author simply e-mailed the CSO requesting such information and was able to obtain data on monthly prices of bottled gas, natural gas, electricity, liquid fuels, and solid fuels from the Consumer Price Index dating back to November 1996. This information is summarised in the following two charts.²

Fig.1 compares trends in bottled gas prices with those for natural gas and electricity between November 1996 and August 2002. Natural gas prices remained unchanged over the entire period of almost six years. Bottled gas prices, on the other hand, increased by just over 23% over the same period. It is generally recognised that, while the fact that prices of two products move closely in line with one another does not prove that they are both part of the same market, the fact that prices of two products do not move closely in line with one another establishes that they are in separate markets. The behaviour of natural gas and bottled gas prices are not consistent with the two products being part of the same market. If we apply the question posed by the SSNIP test, the price data indicates that a firm with a monopoly in bottled gas could profitably impose a small significant price increase as consumers would not switch to natural gas in sufficient numbers to make the price increase unprofitable.

² As there were five sets of prices, two charts are used for purposes of clarity, rather than having all five series on a single chart.

Fig.1: Prices of Certain Household Fuels
(Nov 1996 = 100)



Source: CSO

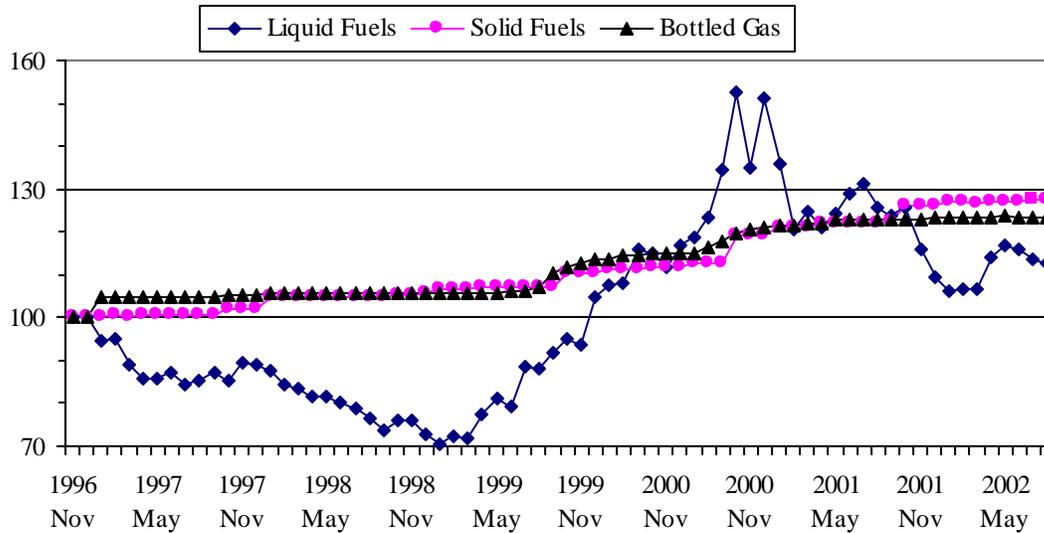
Fig.1. also shows that electricity prices remained virtually unchanged from November 1996 until the CER approved an ESB price increase in October last year. In other words, the chart also supports the view that bottled gas and electricity are not in the same market. The reason that gas and electricity prices did not increase is because they are subject to government control or regulation. For the purposes of market definition this does not matter.

Fig. 2 compares trends in bottled gas prices with those for liquid and solid fuels. The chart shows that the price of liquid fuels, which includes heating oil, fluctuated quite considerably over the period. Liquid fuel prices in January 1999 were 30% lower than in November 1996, while bottled gas prices increased by almost 6% over this period. Prices of liquid fuels in the final quarter of 2000 were 50% above their November 1996 level. They fell back considerably over the following 18 months and in August 2002 were just 13% above their November 1996 level. Bottled gas prices have clearly not been subject to the same dramatic swings as liquid fuels. They have, however, risen steadily over the

period and, as noted previously, by August 2002 they were 23% higher than in November 1996. Movements in the two price series over this period of almost six years are inconsistent with both of them being in the same market.

Fig.2: Prices of Selected Household Fuels

(Nov 1996 = 100)



Source: CSO

In contrast to the other three fuels examined, movements in solid fuel prices appear to closely match those of bottled gas. It must be stressed again, however, that the fact that prices are highly correlated does not establish that two products are in the same market. Such correlations might arise for all sorts of reasons. For example, if the demand for two products is highly seasonal, which seems likely in the case of both bottled gas and solid fuels, then the prices will be closely correlated even though the two are not necessarily in the same market.

Another possible explanation for the similarity in bottled gas and solid fuel prices is that what we may be seeing is an example of the ‘cellophane trap’. Essentially this states that a firm or firms which have a dominant position will raise their price as high as possible, i.e., until they reach the point where consumers would ultimately switch to an alternative. As famously happened in the *Cellophane* case in the US in the mid 1950s, asking

whether two products are in the same market on the basis of prevailing prices in those circumstances will result in the market being wrongly defined and an incorrect finding that a firm is not dominant. The question in such circumstances is not whether the two products are close substitutes at prevailing prices but whether they are close substitutes at competitive prices. Clearly actual price data cannot answer that question.

Bottled gas can be used for cooking and heating, while solid fuel is used mainly for heating, although there is a small amount used for cooking. In the cooking segment it seems highly unlikely that the two are close substitutes. Similarly, the fact that both fuels are not directly interchangeable suggests that they are unlikely to be close substitutes in the case of heating, at least at competitive price levels. Effectively to be considered as close substitutes there would have to be sufficient numbers of consumers who have both fires and bottled gas heaters in their homes and who would switch from using one to the other on the basis of a small price increase in one or the other.

Effectively what the price data show is that bottled gas is not in the same market as electricity, natural gas or liquid fuels. The position regarding solid fuels is inconclusive on the basis of the price data, although there are reasons for doubting that the two are close substitutes. The results in that case might be due to either a spurious correlation or might be an example of the cellophane fallacy. The evidence therefore suggests that bottled gas is a distinct product market.

This begs the question why the Authority sought submissions on the question of market definition rather than carrying out its own market analysis. Here is an example where price data on all of the products that might constitute the relevant market is readily available. As the Authority has stated that it was in the process of analysing exclusive dealing agreements for LPG last July one might have expected it to have undertaken such an analysis, especially as the agreements it was analysing were notified in 1999.

Analysing the Effects of Exclusive Dealing Agreements.

A review of the economics literature suggests that vertical restraints ought not to be considered *a priori* anti-competitive. Nevertheless, there is a body of research which shows that vertical restraints may be harmful in certain circumstances. The mainstream economic viewpoint appears to be that vertical restraints such as exclusive dealing need to be addressed on a case-by-case basis.

The EU Commission has stated that:

‘The fiercer is interbrand competition, the more likely are the pro-competitive and efficiency effects to outweigh any anti-competitive effects of vertical restraints. Anti-competitive effects are only likely where interbrand competition is weak and there are barriers to entry at either producer or distributor level. In addition, it is recognised that contracts in the distribution chain reduce transaction costs and allow the potential efficiencies in distribution to be realised. In contrast, there are cases where vertical restraints raise barriers to entry or further dampen horizontal competition in oligopolistic markets.’³

Dobson and Waterson⁴ advocated a three-stage approach for establishing whether it is likely that a particular set of vertical restraints would operate against the public interest as follows:

- Vertical restraints are unlikely to be harmful in the absence of market power. Consequently, the first step is to assess whether or not there is market power in either the upstream (supplier) or downstream (retailer) market;
- The next step is to assess the actual effects of the vertical restraints on competition in the particular market; and
- The third step is to consider whether there is evidence of increased efficiency as a result of the restraints.

³ EU Commission, (1997), *Green Paper on Vertical Restraints in EU Competition Policy*, Brussels: EU Commission, p.iii.

⁴ P.W. Dobson, and M. Waterson, (1996): *Vertical Restraints and Competition Policy*, Office of Fair Trading, Research Paper 12, London: Office of Fair Trading. A similar check list was proposed by London Economics, (1997): *Competition in Retailing*, Office of Fair Trading, Research Paper no.13, (September), London: Office of Fair Trading.

This checklist can be readily applied to the case of cylinder LPG in Ireland.

1. Market Power in the Bottled Gas Market.

As stated in the absence of any significant degree of market power at either supplier or distributor/retailer level, economists largely think that vertical restraints are unlikely to have any detrimental effects. London Economics focus in particular on the degree of market concentration and suggest that vertical restraints are more likely to have anti-competitive effects in highly concentrated markets. The bottled gas market in Ireland is highly concentrated. There are two large suppliers, one with a market share of around 60% and the other with a market share of around 30% with a small competitive fringe consisting of two or three firms with a combined market share of around 5%. While market shares of themselves are not conclusive, such a market structure would suggest that the bottled gas market is characterised by market power at supplier level.

Dobson and Waterson point out that one indication of market power is the ability of a firm to impose certain conditions on its customers or suppliers and argue that if a vertical restraint is imposed by a manufacturer, as opposed to being the result of a mutual agreement, it is rather likely that it operates in conditions where it is socially desirable that it should not operate. The indications are that the motivation for exclusive dealing comes from the two main suppliers. Certainly, in the past the smaller competitive fringe suppliers have made submissions opposing such arrangements.

2. Impact of Exclusive Dealing on Competition.

In an oligopolistic market where two firms account for more than 90% of the market interbrand competition is unlikely to be all that strong. Consequently, any weakening of intrabrand competition may be expected to have undesirable consequences. Thus, in the absence of clear evidence of strong interbrand competition, exclusive dealing arrangements for bottled LPG are likely to be harmful. The Authority would appear to be better placed than third parties to undertake an assessment of the intensity of interbrand competition in the bottled gas market. For example, it could look for data on wholesale and retail prices of the two main suppliers over the past number of years.

3. Efficiency Gains.

In circumstances where non-price vertical restraints are deemed to have adverse effects on competition the final question, according to Dobson and Waterson, is whether these are outweighed by efficiency gains. Similarly, London Economics argue that, if vertical restraints cannot be explained in terms of significant efficiency gains, then they are almost certainly anti-competitive. The available evidence does not tend to show that exclusive dealing arrangements in bottled gas produce major efficiency gains. On the contrary, as the Authority noted in its original decision to grant a category licence for exclusive dealing agreements with a maximum duration of two years:

‘There are a large number of LPG dealers in the State, most of whom sell only a fairly small number of cylinders. Very many dealers sell, on average, less than ten cylinders a week. There would thus not appear to be any economic or efficiency gains as a result of the exclusive purchasing arrangements.’ (Para 42)

4. Economies of Scope in Retailing.

Another factor of key importance in the assessment of non-price vertical restraints is the presence or absence of economies of scope at retail level. As noted previously social welfare is more likely to be reduced when economies of scope in retailing are high and when interbrand and intrabrand rivalry is relatively weak. Where there are economies of scope in retailing, both society and manufacturers can gain from having retailers stock competing products as this increases final output. In the case of bottled gas there are likely to be significant economies of scope at retail level.

Casual observation from visits to France indicates that competing brands of LPG are sold by the same retail outlets there. Again, however, given the Authority’s contacts with other competition authorities, it should be better placed than independent third parties to ascertain how bottled gas distribution agreements are treated elsewhere.

5. Evidence on Raising Rivals’ Costs.

A further indication of the effects of exclusive dealing on competition in the bottled gas market can be obtained by considering the data on dealer numbers and market shares which were included in the Authority's category licence for exclusive dealing agreements of two years or less. These are reproduced in the following table. The figures show that the second largest supplier, Flogas, had a market share which was half that of the largest firm, even though it had 13% more exclusive dealers. The number three firm had one third the number of dealers that Calor had but it had a market share which was only one twelfth that of the leading firm. In effect this indicates that the first firm into the market had secured exclusive access to all of the best dealers and thus has a far larger market share. Other firms face higher costs because they are forced to rely on the less effective dealers. Such results are more in tune with a picture of exclusive dealing arrangements as a mechanism for 'raising rivals costs' and preventing entry, rather than a means of increasing efficiency.

Dealer Numbers and Market Shares in Bottled Gas

	Number of Dealers	% Market Share
Calor	3,000	60
Flogas	3,400	30
Blugas	1,000	5

Source: Competition Authority, Decision Number 364.

Some Conclusions.

In 1994 the authority refused licences (exemptions) to five-year exclusive dealing agreements for bottled gas. Instead, it issued a category licence to agreements with a maximum duration of two years. It also imposed a number of reporting requirements on LPG suppliers indicating that it had serious concerns about the benefits of exclusive dealing in the industry. In October 1999 the Authority decided not to renew the category licence for such arrangements and to exclude them from the category certificate/licence on vertical restraints. Unfortunately, it failed to give any reasons for this.⁵

The announcement that the Authority is now considering making a declaration with respect to exclusive dealing agreements for bottled gas and inviting submissions raises some serious issues.

The Notice provides no insights regarding the Authority's views on the economic justification for such a declaration in contrast to the procedures previously adopted in the case of category licences under the old legislation, thus making it difficult for third parties to comment meaningfully.

The evidence on price data for various fuels, which is readily available, indicates that bottled gas constitutes a separate product market. Since the original 1994 decision economic analysis has emerged which enables one to identify more clearly the circumstances in which vertical restraints may prove harmful. The evidence indicates that the circumstances which prevail in the cylinder LPG market in Ireland are those in which exclusive dealing agreements are likely to be harmful to competition rather than pro efficiency. This begs the question of whether such issues should have been analysed and addressed by the Authority before it decided to propose a declaration permitting such arrangements.

⁵ The author was a member of the Authority at that time.