Fare Play to You?

Authority Rules Against Statoil's Pricing Strategy.[1]

Introduction.

On 4th November 2003, the Competition Authority issued an "enforcement decision" in respect of price support agreements ("PSA") between Statoil Ireland Limited and a number of petrol retailers.

The retailers purchased motor fuels on an exclusive basis from Statoil. The Authority's "enforcement decision" raises a number of important economic and legal concerns which are considered in the present article. The decision seeks to expand the boundaries of section 4(1) of the Competition Act 2002 ("the Act") quite considerably.

Undoubtedly, an enforcement agency should seek to clarify the scope of its enforcement legislation, and the signs of a more activist approach to enforcement are to be welcomed. The decision in this instance, however, seems to raise more questions than it answers.

Background.

In the course of an investigation into suspected resale price maintenance (RPM) in Letterkenny by Statoil and certain motor fuel retailers, the Authority became aware of the operation of the PSA between Statoil and its selected retailers. The PSA provided financial support to certain Statoil retailers to enable them to match the price of specified competing retailers.

Under the PSA, the Statoil retailers were not allowed to charge more than the Statoil recommended retail price, and would not receive financial assistance for any cuts in retail price below the retail price of specified competing retailers. Under the terms of the PSA, Statoil provided 'margin support' in the form of covering half the cost of the reduction in retail price by its retailer to meet the retail price of the designated competitors.

While the Authority closed its investigation into RPM, it concluded that the PSA infringed the Competition Act 2002. Statoil subsequently agreed to terminate all PSAs nationwide.

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[1] Co-authored with Daragh Daly.

The Economic Evidence.

The Authority uses three different approaches to evaluate the effects of the PSA, namely:

1. A theoretical analysis of the influence of the PSA on the incentive to cut prices;
2. The testimony of the station owners; and
3. The actual pattern of prices.

The Authority's theoretical analysis is based on a stylised theoretical model of competition in an oligopolistic market. The model incorporates a number of simplifying assumptions.

- Each retailer has one third of the market;
- Retailers margins prior to any price cut amount to 5c per litre;
- Non fuel costs do not vary with the quantity sold;
- Aggregate petrol sales are insensitive to price;
- A price cutting firm can only increase its sales by attracting customers from firms that do not cut prices;
- One firm is committed to matching any price cuts.

Based on these assumptions the Authority seeks to demonstrate that the PSA reduced the incentive to cut price and, hence, dampened price competition on the grounds that the volume of business that a price cutter would have to capture from the one non-price cutter was too high to be credible. The Authority then seeks to apply this to the Letterkenny case by arguing that the market shares of the Statoil stations and their main rivals are so high that the result predicted in the model would be likely to apply.[2]

There are two fundamental problems with the Authority's economic analysis.

Significant Lacuna in Reasoning.

First, the Authority correctly states that it is widely recognised in the economics literature that price matching supports the absence of price competition because it prevents rival

[2] Interestingly, it adds the market shares of other firms to those of the retailers concerned on the grounds that the former tended to follow prices set by the larger retailers. Augmenting the market shares of the larger retailers in this way reduces the share of the market that is up for grabs in the event of a price cut

firms from gaining market share.[3] The literature, however, generally argues this in the context of rival oligopolists, i.e. one firm, by signalling a commitment to match price cuts, can discourage its rivals from cutting prices. This investigation, however, involved vertical arrangements between a supplier and its distributors.

The Authority offers no explanation as to why Statoil would want to enter into an arrangement that reduced competition between downstream retailers. The essential Chicago argument in favour of vertical restraints is that it is not in suppliers' interests to restrict competition among their retailers and they will therefore only impose restrictions on retailers that are efficiency enhancing because, otherwise, it will reduce the supplier's sales and profits.

The counter to this argument is that by imposing restraints on downstream retailers, suppliers may dampen competition in the upstream supply market. The Authority document says nothing about competition (or the absence thereof) in the upstream market. This is a significant lacuna in the Authority's reasoning.

Price Competition is Unlikely *Without* the Price Supports.

The second difficulty with the Authority's reasoning relates to its analysis of the impact of the PSA on competition among the retailers.

In a market where there are three equally sized firms, as outlined in the Authority scenario, there would appear to be little incentive for retailers to compete on price in the absence of the PSA. Filling stations are legally required to display their prices prominently, so secret price cuts are simply not an option. The only reason why an individual retailer would want to cut price is to attract customers from its rivals.

A rational firm, however, would recognise that, if a price cut took customers from its rivals, they would almost certainly retaliate. [4] The net result would be to leave sales and market shares unchanged but prices and margins lower than they were before.[5]

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from 41% to 23%; thus, reinforcing the claim that the amount of business price cutters would have to capture from non-price cutters is too high to be credible.

[3] It cites more than ten academic references on this point.

[4] The Authority's argument that the retailer that is not party to the PSA would not respond to price cuts by the other two retailers seems highly unlikely. Indeed, they produce no evidence to support such an assertion.

Thus, there is no benefit from cutting prices. In other words, given the Authority's stylised model one can show that price competition is unlikely absent the PSA.[6]

Evidence Neither Consistent Nor Conclusive.

The Authority advances two other arguments in support of its findings.

First, it states that the evidence of the filling station owners that it interviewed "is largely consistent" with its view of "how the PSA influences the incentive to cut price." The evidence of the station owners raises a number of legal points which are considered below. The decision, however, states that one filling station owner indicated that the existence of the PSA removed the incentive for him to reduce prices, while another said it did not affect his pricing decision. This is hardly consistent or conclusive.

The second additional argument relies on information regarding the actual prices charged by the retailers, and it includes a table giving prices for 7 different dates over a period of 7 months. This shows considerable price uniformity with the exceptions largely dismissed as being possibly due to differences in the time at which prices were checked, or, because one or more retailers were a little behind in changing their prices. Leaving that point aside, the fact is that uniformity in prices could be the result of parallel behaviour by rival oligopolists. Of itself such evidence is not conclusive one way or the other.

In effect, it is possible to come up with an alternative theoretical explanation of the facts than the one put forward by the Authority, which suggests that the evidence is not as clear as the decision suggests.

Legal Issues|: Silence on Plausibility of Anti-competitive 'Effect'.

The Authority considers that "it is not clear that the object of the PSA can necessarily be considered anti-competitive." It therefore rests its entire case on what it considers to be the 'effect' of the PSA on a nationwide basis. The Authority cites no legal precedents in

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[5]If an individual retailer was unsure about the likely reaction of its rivals to a price cut, it would be relatively easy for it to find out by cutting price. If its rivals followed suit it could quickly reverse its price cut. At that stage all of the retailers would know that a price cut did not make sense.

[6] It could be argued that a commitment to match price cuts that is backed by financial support from the supplier is more credible, but that again begs the question of what is the benefit of such an arrangement for the supplier.

support of its findings. Indeed, it points out, in a footnote, that the Dutch Competition Authority concluded that a price matching scheme was not anti-competitive but goes on to state:

> "However, it should be noted that the Dutch analysis was largely theoretical in nature and, unlike the Authority's investigation in Letterkenny, the Dutch authority could not demonstrate that the price-matching schemes in place had an anti-competitive effect in the market."

While the Authority references legal text and case law in discussing what constitutes an "agreement, decision and concerted practice," and what constitutes an anti-competitive "object" for the purposes of the Act, it is conspicuously silent as to the legal standard it is expected to achieve in determining what amounts to an anti-competitive "effect" for the purposes of the Act.

The precedent from both the European Commission and Courts shows that 'effect' is to be interpreted as both the actual and potential effect on competition in the relevant market. This entails an actual examination of the relevant market(s). However, any potential effect is qualified so that "an economically realistic approach is necessary in the assessment of any particular case."[7]

Furthermore, case law also establishes that the effect of the agreement should be considered in the context of the competition that would occur in the absence of the allegedly anti-competitive agreement.[8]

Economic theory, of itself, cannot constitute evidence required to prove breach of competition legislation, a point noted by Judge Brennan in Drogheda District Court, when dismissing charges of entering an agreement which had the effect of preventing, restricting or distorting competition which the Authority had brought against a number of farmers.

> "It is quite correct that in theory if one does something that has a restrictive effect there will be an implication, but in a court case there must be evidence."[9]

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[7] Cases T-374/94, etc., *European Night Services v. Commission* [1998] ECR II – 3141.
[8] Case 56/65 *Technique Miniere* [1966] ECR 235
[9] *Competition*

It is at least questionable whether it is economically reasonable to propose that Statoil, in the absence of any evidence of upstream anti-competitive behaviour, would wish to dampen downstream competition between its retailers and rival retailers.

The Authority also fails to consider the state of the market in the absence of the PSA. As already outlined, there is every reason to believe that the absence of the PSA would not have any significant pro-competitive impact in Letterkenny. The evidence of the two selected rival retailers is contradictory, as one of them stated that the existence of the PSA "did not affect his pricing decision."

In addition, the Authority has not considered pricing data preceding implementation of the PSA.

Furthermore, the Authority's evidence is confined to an assessment of the Letterkenny market only, and does not consider the "effect" of the PSA nationwide.

Therefore, it is unclear how the Authority can reasonably conclude that the PSA has an anti-competitive effect nationwide.

Have You Considered How Your Agreement Affects Potential Competition?

The analysis contained in this decision also raises more general legal concerns. The decision finds an agreement between two parties has the effect of preventing, restricting or distorting competition because it reduces the incentive for a third party, who is not party to the agreement, to compete with one of the agreement parties. This has some far-reaching implications. Parties entering into an agreement may, on the basis of this decision, need to take account of how it might affect the incentives facing third parties.

No Statutory Basis for 'Enforcement Decisions'.

There is no statutory provision in the Authority's enabling legislation for this type of enforcement decision making. Indeed, the 2002 Act abolished the previous ex ante notification system, whereby agreements could be notified to the Authority for an opinion as to whether or not they were anti-competitive.

The Authority's Annual Reports for the 1996-99 period record that, in a number of instances, including several cases of alleged RPM, parties agreed to discontinue certain practices following objections by it.

How is Legal Certainty Enhanced?

The primary rationale stated by the Authority for such enforcement decisions is the creation of legal certainty.

It is difficult to see how this decision contributes to such certainty. It has interpreted the concept of anti-competitive "effect" in an unprecedented manner, namely, proposing an economic model and creating a hypothetical scenario in which to propose an anti-competitive effect, with little supporting evidence.

Furthermore, it has failed to explain why it has discounted any other economic model which might explain the behaviour it is investigating. It is difficult to see how this precedent will assist competition lawyers in advising their clients, since they are unlikely to be appraised of all the economic literature which might be used by the Authority to bring an action against their clients, or second guess how the Authority will interpret the wording in the legislation. The effect of the decision is, therefore, to reduce legal certainty.[10]

Decision Lacks Discipline of Enforcement by Courts.

Arguably it is with good reason that enforcement decisions should be taken by the Courts. The Irish legal system separates the judicial decision maker from the prosecutor. This can facilitate a more objective assessment of arguments and evidence by the decision maker who does not have a vested interest in the outcome of the decision. The evidence forming the basis of such a decision can be robustly examined, and each party can give evidence and cross examine the evidence of the opposing party. In contrast, the Competition Authority's investigative procedures do not allow the parties under investigation to cross examine witnesses or to introduce witnesses of their own.

It is clear that, where an enforcement body is both investigator and decision maker, the quality of reasoning and evidence can be compromised. An example of this can be found in some recent Court of First Instance reviews of merger decisions by the European

[10] The Authority may well seek to use its body of enforcement decisions as precedents in subsequent legal cases it brings.

Commission which criticised the quality of analysis and conclusions contained in the Commission's decisions.[11]

The discipline of taking legal action in respect of enforcement activity, as envisaged under the Act, therefore reduces the likelihood of enforcement decisions which manifest errors in law or may be unreasonable in their conclusions. If the Authority were required to justify its decision in a court, it would have the foregoing legal obstacles to overcome. Furthermore, it would present an opportunity for the defence to put forward alternative economic models (such as parallel behaviour), and there would need to be clear reasons advanced as to why such alternative models could not explain the alleged behaviour in order for the Authority to succeed in its action.

Of course, it might be argued that Statoil would not have agreed to discontinue such behaviour unless the Authority's arguments were justified. Alternatively, it may simply have decided that it did not want to spend a lot of time and money debating academic economic points before the courts.

The Authority can correctly argue that it does not need to pursue injunction proceedings when a party has agreed to discontinue the behaviour it was objecting to. Where, however, the Authority is seeking to expand the interpretation of what constitutes an anti-competitive agreement, it would appear preferable for it to seek declaratory relief. Novel interpretations of the legislation should be decided by the courts in order to clarify the law.

Competition Authority Should Act Transparently & Consistently.

The Authority's actions in this case also raise some wider questions regarding consistency and transparency of a statutory body. Shortly after the Authority's announcement in Statoil, it settled proceedings it had instituted against the LVA in the High Court five years earlier in return for undertakings furnished by the latter body. As part of that settlement, the Authority agreed that there would be no further disclosure regarding that case.

[11] See for example case T-342/1999, Airtours plc v Commission. (Judgment of the Court of First Instance on 6th June 2002) and case T-310/2001, Schneider Electric SA v. Commission (Judgment of the CFI on 22nd October 2002).

This begs the question of why, in some instances the Authority publicises the results of its investigations (and sets out its reasoning for its actions) and does not do so in others. The Authority, as a public enforcement agency, operates in the public interest and, therefore, such civil proceedings differ from disputes between private parties.

Where the Authority agrees to accept undertakings in Court from parties in settlement of proceedings, there would appear to be a public interest argument that the nature of the alleged breach of the Act and evidence to support such allegations, if any, should be disclosed.

In deciding to publish ‘enforcement decisions’ the Authority is acknowledging this argument. The terms of the LVA settlement exposes the Authority to criticism of inconsistent behaviour arising from its enforcement mandate.

Secret Settlements by Competition Prosecutor Prohibited in US.

In the United States, the Tunney Act requires that settlements in competition cases must be approved by a federal court. This is designed to prevent the authorities from cutting secret backroom deals with specific defendants. It also acts as a safeguard against “false positives”. The court must review the settlement, hear arguments from all interested parties, and determine that the settlement is in the public interest. Such a requirement would provide greater transparency and legal certainty than the Authority’s existing practices.

In the early 1990s, for example, the Justice Department challenged arrangements relating to the selling of tickets by rival airlines. The Department alleged that the computerised ticket booking system was being used to collude. The case clearly sought to expand the definition of what constituted an agreement. When two airlines agreed to discontinue certain practices, the other airlines were able to challenge the settlement and dispute the Department’s claim, although their arguments were ultimately rejected.

While the court’s acceptance of a settlement does not constitute a legal precedent, it does nevertheless allow parties the opportunity to present their arguments to the courts and provides an opportunity to clarify what behaviour is and is not likely to be acceptable.