The Curious Case of the Dog that Didn't Bark -

Some Thoughts on the Competition Authority Declaration on Exclusive Dealing in Cylinder LPG (with due acknowledgement to Sir Arthur Conan Doyle).[1]

On 21st March 2005, the Competition Authority announced that it had decided to make a Declaration permitting exclusive dealing agreements of up to two years duration in the case of cylinder LPG.

This decision follows a long drawn out and somewhat unsatisfactory consultation process. It began with the publication of a consultation paper in September 2002, which was subsequently, withdrawn. The Authority then instituted a second consultation in September 2004.

In the announcement of the decision to make a Declaration permitting two-year exclusive dealing agreements there is nothing to suggest that such arrangements will address the serious competition problems which the Authority has identified in this market.

Questions also arise as to why the Authority has failed to investigate the fact that "changes in the price of cylinder LPG by Calor and Flogas tend to mirror each other" given that the market has particular features that raise concerns about the potential for "coordinated behaviour".

Background.

Following the passage of the Competition Act, 1991, both Calor and Flogas notified five year exclusive dealing agreements for cylinder LPG (bottled gas) to the Competition Authority, requesting a certificate or, failing that, a licence.

In 1994 the Authority refused to issue certificates or grant licences to the notified agreements. Instead it issued a category licence for exclusive dealing agreements with a

maximum duration of no more than two years.[2] In October 1999 the Authority decided not to renew the category licence when it expired.

Exclusive dealing agreements in respect of cylinder LPG were excluded from the Authority's category certificate/licence on vertical restraints[3] and from the Authority's Declaration on vertical agreements, issued in accordance with the provisions of the new 2002 Act.[4]

Calor and Flogas notified exclusive dealing agreements for cylinder LPG to the Authority in late 1999.[5] Both firms have been signing five-year exclusive dealing agreements with retailers since that time, although Calor also signed a relatively small number of agreements of a shorter duration.

In September 2002, the Authority issued a consultation document indicating an intention to issue a Declaration in accordance with Section 4(3) of the 2002, Act. It subsequently announced that it was terminating the consultation process, while indicating that it would institute a new consultation at a later stage.

The Authority subsequently issued a new consultation paper in September 2004.[6] In that paper, the Authority outlined at length why, in its view, five year exclusive dealing agreements in the cylinder LPG (bottled gas) market were anti-competitive and did not satisfy the requirements of section 4(5) of the Act.[7] The Authority also indicated that, in its view, two year exclusive dealing might not satisfy all of the requirements of section

---

[1] The author was a member of the Authority when it decided to grant a category licence for two-year exclusive dealing agreements in 1994. Compecon has made submissions to the Authority arguing against any exclusive arrangements.
[2] Competition Authority, decision no.364, 28.10.1994.
[3] Competition Authority, decision no.528, 4.12.1998.
[4] Competition Authority *Declaration in Respect of Vertical Agreements and Concerted Practices*, Decision no.3/001. The Declaration replaced the earlier category licence.
[5] Flogas also notified a two-year exclusive dealing agreement.
[6] Competition Authority, (2004): *Consultation on a Declaration in the Cylinder LPG Market,* September 2004. Under Section 4(3) of the Competition Act, 2002, the Authority may declare that a specified category of agreements satisfies certain criteria which are set out in section 4(5).
[7] Section 4(2) of the 2002 Act provides that an agreement deemed anti-competitive under section 4(1), shall not be prohibited if it meets all of the requirements of section 4(5).

4(5),[8] and that they might foreclose the market and afford the possibility of eliminating competition, although this "might not occur if exclusive dealing agreements were limited to one year."[9]

The Authority also raised some very serious questions about pricing behaviour in the market. The consultation paper outlined three possible options on which it invited submissions from interested parties:

(i) A declaration allowing two-year exclusive dealer agreements;

(ii) A declaration allowing one-year exclusive dealer agreements; or

(iii) No declaration.

Economics of Vertical Restraints.

There is an extensive economic literature dealing with the impact on competition of vertical restraints such as exclusive dealing agreements. This literature indicates that vertical restraints cannot be deemed automatically pro- or anti competitive, but rather their effects depend on the particular facts of any individual case. It indicates that vertical restraints such as exclusive dealing are likely to prove anti-competitive in markets where:

(a) Suppliers and/or retailers have some degree of market power;

(b) Interbrand competition is relatively weak; and

(c) There is little evidence of efficiencies.

The Authority's consultation paper indicated that all three of these conditions appear to be met in the case of cylinder LPG. The literature also indicates that, where economies of scope in retailing are high and inter and intrabrand rivalry are both relatively weak, allowing retailers to stock competing products is likely to be beneficial.

The literature also recognises that vertical restraints can represent a means of raising rivals' costs, thereby preventing entry and reducing competition. It has been shown that a

[8] Para 3.29.
[9] Para 3.43.

firm with market power can use vertical restraints to achieve anti-competitive price increases and/or market foreclosure.[10]

Acquiring control over distribution outlets in order to deny rivals access to such outlets is often cited in economics textbooks as an example of a raising rivals' cost strategy.

Impact of Exclusive Dealing on Competition in Cylinder LPG.

The two largest LPG suppliers have a combined market share of 98%, which would certainly lead one to suspect the existence of market power.

The Authority also found that the exclusive dealer agreements reduce interbrand competition in the LPG market, in particular with respect to price.

> "The degree of price competition in the cylinder LPG market does not appear to be intense. The Authority has information suggesting that changes in the price of cylinder LPG by Calor and Flogas tend to mirror each other. Such pricing patterns are consistent with an absence of aggressive price competition in the cylinder LPG market."[11]

An obvious question arises as to just how closely the two main firms' price changes mirror one another.

The authority consultation paper also found that the cylinder LPG market displayed a number of features that have been identified as tending to facilitate collusion. These included:

- A high degree of market transparency;
- Product homogeneity;
- Similar cost structures; and
- Multi-market contact.

Although the consultation paper claimed that Calor and Flogas had similar cost structures, the Authority subsequently indicated that it "accepts that Calor and Flogas

[10]D.T. Scheffman and R. Higgins, (2004): 20 Years of Raising Rivals' Costs: History, Assessment and Future, *George Mason University Law Review*, also available at www.ftc.gov/be/rrcgmu.pdf

may not have similar cost structures due to the latter operating through a distributor network."[12]

It appears that the Authority does not know whether or not the firms have similar cost structures, although this is an important factor in explaining parallel pricing behaviour.

The consultation paper further states:

> "These agreements can thus be regarded as a method of discouraging consumers from switching brands and as a binding mechanism that reduces interbrand competition, thus reducing the need for collusion."[13]

The Authority noted that the most intensive users of cylinder LPG are those with lower incomes. In other words, it is less well-off consumers who suffer disproportionately as a result of the lack of competition in cylinder LPG.

Parallel price behaviour does not, of course, constitute evidence of collusion. When such behaviour is combined with factors known to facilitate collusive behaviour, it merits some explanation. As the Authority put it:

> "…the cylinder LPG market has particular features that raise concerns about both the potential for coordinated behaviour and the degree to which price competition may be dampened in the market."[14]

The findings regarding price competition in the cylinder LPG market suggest, at the very least, that the Authority might need to get off the ditch and launch an urgent investigation into such pricing behaviour. This could be done by examining price data along with information on firms' cost structures and production capacities.[15] The Authority clearly

---

[11] Para 2.40.
[12] Competition Authority, (2005): Consultation on a Declaration in the Cylinder Liquefied Petroleum Gas Market, Summary Report on Submissions, 21st March 2005, para 2.54.
[13] Para 2.69
[14] Para 2.70.
[15] A study of pricing behaviour in the UK salt industry, based on information published in a report by the MMC, adopted such an approach to show that the pricing behaviour of the firms concerned could only be explained by collusion. R. Rees, (1993): Collusive Equilibrium in the Great Salt Duopoly, *Economic Journal*, 103:833-48

has the power to obtain the information necessary for such analysis. At the very least by undertaking such an exercise, the Authority could clarify the situation.

But Holmes, the dog didn't bark.

The Authority has chosen to issue a Declaration permitting two-year exclusive dealing agreements for cylinder LPG. This represents a significant about turn compared with the September 2004 consultation paper, which identified various reasons why such arrangements might not satisfy the requirements of Section 4(5), with no real explanation for this change of view.

The Authority has advanced little evidence to support a finding that such agreements satisfy the requirements of Section 4(5). In its March 2005 Summary Report of Submissions for example, it states at para 2.86 that, in the absence of exclusivity, "inefficiencies may arise in the distribution of cylinder LPG to retail outlets". Yet on the previous page, in para 2.79, it states that it "is therefore not convinced that a multi-brand environment will give rise to inefficiencies". As with claims of similarities in firms' cost structures, the Authority's position appears somewhat unclear.

More Questions Raised than Answered.

The Authority's decision relies heavily on the fact that during the 1994-99 period when exclusive dealing agreements were limited to two years, smaller suppliers managed to secure a 7% share of the market. Even if small firms could somehow regain their 1998 market share, the two main suppliers would still have 93% of the market, hardly a competitive situation. There is no basis for believing that reducing the duration of such agreements will address the lack of competition in this market and result in any increase in interbrand competition.

The Authority's decision raises more questions than it answers, particularly with regard to pricing behaviour in this market. As Stelzer (2001, p.122) observed, in the case of UK regulatory authorities:

> "A simple recitation of each party's contentions, followed by unexplained conclusory paragraphs is not enough."

The failure to investigate industry pricing behaviour, in spite of disturbing evidence, constitutes a particularly glaring omission.