B

Agreements between firms

Introduction

Any contract between firms limits the freedom of the parties involved. Even a simple contract to deliver 100 widgets next month at price €1,000 restricts the buyer's ability to switch to a lower-cost provider in the meantime and, if there are capacity constraints, also the seller's ability to supply one of the buyer's rivals. This is an example of a simple vertical contract. Such contracts are the essence of everyday business practice. They enhance the efficiency of trade and encourage investment. Freedom to engage in such contracts and the institutional environment that allows them to be enforced are essential ingredients to a well-performing market. The competition problems arise when contracts are used beyond this to include clauses that more directly exclude or suppress competition. Horizontal agreements (i.e. between alternative suppliers) ring a very direct warning bell of coordination for customer exploitation. When the agreement is vertical (i.e. between buyer and supplier) competition concerns usually relate to the potential exclusion of rivals which may then indirectly harm consumers. The common theme in this part of the book is the identification and deterrence of agreements that are harmful in their effects.

All of the cases in the following chapters relate to the enforcement of Article 81 of the EU Treaty (or the equivalent national provision). Article 81 prohibits any agreements or concerted practices 'which have as their object or effect the prevention, restriction or distortion of competition within the common market'. Examples include agreements that 'directly or indirectly fix purchase or selling prices or any other trading conditions', 'share markets or sources of supply' or 'apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage'. If a contract breaks the Article 81 prohibition, it is illegal and cannot be enforced. However, unlike the Article 82 prohibition, it is possible to argue for exemption under Article 81(3). This allows an agreement 'which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit'. Either an individual agreement may be exempted or, in the case where a particular type of agreement is commonplace, a class of agreements satisfying certain properties may be given a block exemption (usually relating to a particular industry).[1]

The first pair of cases relates to secret price-fixing cartels, for which there is no possibility of exemption. Cartels have become a major priority for EC competition policy. The main economic harms are textbook monopoly price raising and the stifling of the wider competitive process of improving offers to fight for customers. Although econometric evidence can be used to identify suspicious pricing patterns, there is little subtle economics in identifying a cartel.[2] EC investigation of international cartels has frequently been prompted by prior discovery by authorities in the US. The evidence usually comes from a whistleblower or incriminating documents and e-mails found in a 'dawn raid' on businesses under suspicion. In order to encourage whistleblowing, the EC first introduced a leniency scheme in 1996, with the latest revision in 2006. Leniency offers a reduction of the fine if a firm comes forward with evidence of a cartel, even if it has been a participant in the recent past.

The graphite electrodes cartel was a global conspiracy involving eight suppliers in Europe. They were fined a total of around €170 million. Hviid and Stephan examine the theory of optimal deterrence to see whether this level of fines is sufficient to deter firms that are economically motivated (i.e. do not obey the law on ethical grounds). They then apply deterrence theory to the case in hand. Fines ranged from less than 1 per cent to 6 per cent of turnover. These are small percentages relative to the price-raising capability of a cartel. They are unlikely to suffice for economic deterrence, especially given the chance of not being caught. The authors work through the EC fining guidelines applied and highlight further weaknesses in the incentives they create. Many of these weaknesses survive in the 2006 revision and the authors conclude that the EC is still not creating the right incentive for firms not to participate in future cartels.

If a cartel's customers were expected to sue for damages, this would be an additional disincentive to their formation. The US system of treble damages is a potent force for litigation across the Atlantic. European legal systems allow

1 The legal niceties need not concern us here, but the legality of restrictive agreements can potentially be argued either under Article 81(1) as pro-competitive or under Article 81(3) as having offsetting efficiencies such that consumers benefit. The essential economic analysis is the same for both, although the latter is clearer in focusing on the effect on consumers.

2 See Porter (2005).

only for single damages (i.e. a victim can claim only for losses shown to have been incurred). Given the chance of losing, this gives a very much reduced incentive to litigate for damages except when law firms offer contingency fees following a successful case brought by a competition authority. Even this is rare in Europe because of problems in proving the degree of harm. However, the EC is actively trying to encourage private actions.[3] Møllgaard considers the district heating pipe cartel in Denmark, Italy and Germany. This ten-member cartel was fined €87 million. It took ten years between the first dawn raid and rejection of the final appeal in 2005. Four Danish municipalities won damages of €21 million. While the EC has only to prove that a cartel existed, a damage claim additionally requires an estimate of the actual harm incurred by the customer. This requires an estimate of how much prices were elevated and how much of this was then passed on to downstream customers. Fortunately, the latter was not an issue for the municipalities because they did not resell the pipes. The author describes the range of methods available for estimating damages and provides an economic critique of the strengths and weaknesses of each.[4]

The next two cases are not of secret price fixing but of publicly known collective pricing agreements that can claim to enhance efficiency due to the presence of externalities. Like the chapter on mobile phone calls, they both involve markets in which there are network externalities between different groups of customers. These have become known as two-sided markets.

Credit and debit cards are increasingly used as a means of paying for transactions. They benefit both customers and retailers as convenient alternatives to cash or cheques (e.g. less risk of theft), so both might be charged for their use. When the customer has a card issued by a different bank to the one used by the retailer, this opens a third possible charge known as the interchange fee. This is paid between the banks to compensate for any imbalance of their customer and retailer transactions. Associations of banks (e.g. Visa, MasterCard) operate these payment-card systems and set the interchange fee and other rules. The fee is usually levied on the retailer's bank and the EC challenged Visa as an agreement between banks that set the fee well in excess of the cost of the transaction. The fee is then passed on to retailers as a high price for Visa services. Rochet identifies the usage externality caused by consumers using a card instead of cash. They cause banks to incur a cost of administering the transaction and retailers avoid the cost of handling cash. Interchange fees can be used to internalise this externality and so reduce distortions in usage. Furthermore,

[3] See EC White Paper on Damages Actions for Breach of the EC antitrust rules; COM(2008) 165, 2.4.2008.

[4] Damages are also discussed in Chapter 10.

competition between banks for customers means that extra revenues gained from retailers find their way into subsidies for customers. The author argues that careful economic modelling reveals no systematic bias and very limited justification for the Commission's price-cap remedy.[5]

The commercialisation of sports creates important interactions between honest and exciting sporting competition and the economic competition which is the focus of this book. The highest-profile cases across Europe have concerned the sale of exclusive TV rights, but competition law can stretch much further. The UK OFT took the British Horseracing Board (BHB) to task over a range of its rules (i.e. agreements) relating to the organisation of fixtures and the way in which non-exclusive rights to take bets were sold to bookmakers. Betting is a distinctive feature of horseracing and has been used to justify much greater state regulation in countries other than the UK, where there is a strong governing authority. Lyons analyses the externalities in this sport to understand the appropriate division between rules supporting good governance to the benefit of consumers and rules that might be an abuse. He identifies several groups of 'consumers' of the sport, including owners, punters and spectators. The author develops a simple model to understand the implications of different types of collective and individual agreement. He finds that the OFT's initial objections to certain rules could have had a seriously adverse effect on the quality of the product enjoyed by most consumers. The OFT was eventually persuaded to revise its position, but some ancillary court decisions on database rights have since undermined what had looked like a good economic effects-based settlement.

The third group of agreements relates to vertical restraints between manufacturers and wholesalers or retailers. Such agreements often have efficiency benefits, including the reduction of double marginalisation,[6] but this does not mean that they cannot also have the effect of distorting competition. Such cases require careful economic analysis and supporting evidence in order to balance the overall effect on consumer welfare.

Car manufacturers have traditionally sold their cars through independent dealerships subject to contracts that limit the commercial freedom of their dealers in a number of ways. These include exclusive territories (dealers must not sell to consumers outside a designated area), selective distribution (dealers must achieve a specified service level or sell a minimum quantity) and

[5] A similar case for MasterCard was settled with a similar remedy in December 2007.
[6] Double marginalisation is where successive stages of production and distribution each add markups which cumulatively may even exceed the integrated monopoly markup.

exclusive dealing (dealers must not sell cars made by other manufacturers). The first two soften intrabrand competition between retailers of the same cars and the third softens interbrand competition between manufacturers (e.g. making it more difficult for consumers to compare cars or new manufacturers to enter a market). However, each restraint can also be justified on efficiency grounds, for example encouraging dealers to invest in local marketing, preventing low-quality retailers from freeriding on the showroom services provided by others (and so undermining the incentive to provide those services) or protecting the investment of manufacturers in training and equipping their dealers. Verboven explores the EC's attitude to these restraints in the form of the evolving block exemption under Article 81(3), observing that the main preoccupation, at least until 2002, was with the common market rather than balancing competition and efficiency. He also takes us through the economic evidence for efficiencies, competition softening and foreclosure effects in relation to cars. He concludes that the EC is moving in the right direction but still has some way to go.

Brewers also have a tradition of exclusive dealing in relation to their 'on-trade' (i.e. selling to pubs as distinct from off-licences and supermarkets for home consumption). The Crehan case concerns both the anticompetitive effect of a form of such exclusivity and the pursuit of damages for the consequences. Waterson tells the tale of one publican's battle against a 'pubco' controlled at the time by the Courage brewery. Pubcos own a large number of pubs which they lease to tenant publicans. Like thousands of other tenants, Bernie Crehan signed a lease for his pub, including an exclusive agreement to buy beer only through the pubco. This is known as tying and is a variant of exclusive dealing – you cannot have one thing (e.g. a pub or photocopier) without also buying your supplies (e.g. beer or paper) from the same firm. The advantage of tying for an independent pubco is that it can use its buyer power to play off one brewery against another and so negotiate advantageous terms. Alternatively, a pubco owned by a brewery secures market share. The problem for the tenants is that their wholesale price is not part of their exclusive purchasing contract but is 'negotiated' under the constraint that the pub cannot buy beer from anyone else. Nevertheless, this apparently vulnerable position may be compensated by other benefits or a lower rent. Mr Crehan went bust in 1993 claiming that this was because his high wholesale price of beer meant he could not compete with neighbouring pubs that could secure cheaper supplies. Although the case formally relates to just one poor publican, it was expected to set a wide-ranging precedent and it reached the highest courts in both the UK and the EU. Waterson sets out the economic analysis and documents the twists and turns of the legal process. He concludes that the final outcome was a victory for arcane legal argument over economic analysis. The case provides a vivid example of the dangers of arguing competition cases before non-specialist courts – especially when it takes thirteen years to reach a conclusion!

The car-distribution block exemption touches on the EC preoccupation with unimpeded trade in a common European market, but the Glaxo case brings it into sharp focus. The case relates to a practice under which Glaxo sold its medicines to Spanish wholesalers at prices differentiated according to where the medicine would be consumed. Thus, the price for a medicine to be sold in Spain was set at the level mandated by Spanish price regulation, but the same wholesaler would have to pay more for supplies to be re-exported to countries willing to pay more, notably the UK. While not explicitly prohibiting parallel trade (i.e. trade by arbitragers in parallel to that by the original manufacturer), the practice had the same effect. The EC prohibited this dual-pricing agreement on *per se* grounds that it impeded trade in the common market. Glaxo appealed the decision. Venit and Rey argue that restraints on parallel trade should not be *per se* illegal and each case should be assessed on its economic merits. They draw on the economics of price discrimination and argue that the EC should have taken account of the fact that pharmaceuticals prices are regulated by national purchasing policies. For example, in the absence of any restraints, low-price countries might not be supplied. Also, if parallel trade was allowed and this drove price down to that of the lowest regulated price, this would undermine R&D incentives. Thus, the Glaxo agreement was in principle justifiable on the grounds of consumer benefit. In 2006, the CFI agreed that restraints on parallel trade should be judged on consumer welfare grounds (i.e. the economic approach). This case shows how the courts can be a positive force for good economic analysis, in particular in promoting consumer welfare as the ultimate focus for competition policy.[7]

[7] Other examples of positive influence can be found in Chapters 14 and 17. Note that while the CFI is not a truly specialised court, competition-related cases form the bulk of its work (unlike for most of the courts deciding Crehan).