CENTRE FOR COMPETITION POLICY

the BA festival of science 2-9 sept 06

‘It’s Bad to Talk’: When Should Firms Talking to Each Other be a Crime?

ESRC Centre for Competition Policy

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E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

UEA NORWICH

The ESRC Centre for Competition Policy

We undertake competition policy research, incorporating ***economic***, ***legal and political science*** perspectives, that has ***real-world policy relevance*** without compromising ***academic rigour***

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The ESRC Centre for Competition Policy

- Interdisciplinary – Economics, Law, Management, Political Science
- Based at the University of East Anglia
- Established in September 2004
- Made up of:
    - 12 Professors & Lecturers
    - 6 Researchers
    - 13 PhD students
    - 3 administrative staff

What We Do

- Research
  - Writing books and articles
- Disseminating our research
  - Publications (academic)
  - Presentations/conferences
  - Talking to practitioners/policy makers
  - Regular newsletter/e-bulletins
  - Press releases/website

Our Research Programme

- This varies over the years, but at present, our main priorities are:
  - Cartels and collusion
  - Mergers
  - Regulation
  - Consumer issues
  - Evolution of competition policy

CENTRE FOR COMPETITION POLICY

Our Survey

Please take 10 minutes to complete our short survey

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COMPETITION POLICY

An Introduction to Cartels

Andreas Stephan

It’s Bad to Talk: When Should Firms Talking to Each Other be a Crime?

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What is a cartel?

A form of cooperation (collusion) between a group of suppliers aimed at suppressing competition between themselves and increasing profits

- Collusive agreements can take different forms:
  - Firms might agree on sales prices (price-fixing)
  - Allocate production quotas among themselves
  - Divide Markets: each company is sole seller
  - Limit or control production: causing prices to rise

Main activities that are illegal

Why are cartels illegal?

- Competition (many companies) is a good thing!
  - Insures firms only charge amount it costs to produce goods, and not more = good for consumers
- Monopoly (one company) is bad!
  - Will want to restrict the amount it produces to raise prices and increase profit = bad for consumers
- Cartels are a way for companies to replace competition by acting as one company (monopolist) – charging artificially high prices

Criminalisation of UK Cartel Policy

1996	→	2006
SLAP ON THE WRIST		5 YEARS IN PRISON + HIGH FINES

s.188 Enterprise Act: guilty if he or she dishonestly agrees with one or more other persons that undertakings will engage in these activities.

Jury must decide *(R v Ghosh):*

(1) if the accused was acting dishonestly according to the ordinary standards of reasonable and honest people (objective);

(2) whether the accused must have realised that what they were doing would be considered dishonest according to the ordinary standards of reasonable and honest people (subjective)

Why can cartels form?

- Few firms in industry
- Hard for new firm to enter industry
- Links with competitors (e.g. R&D)
- Substitutability (how important is product?)
- Product Homogeneity (how similar are products?)

Is forming a cartel difficult?

- Main challenges:
  1. Agreement on prices, sales quantities etc
  2. Implementation of agreement
  3. Monitoring - Detecting and punishing cheaters
  4. Adjusting for fluctuating currency prices and cost shocks

- Mechanics of typical cartel:
  1. Frequent Meetings – agree and monitor
  2. Exchange of information
  3. Buying each others excess produce

The Lysine Cartel

- Lysine is an amino acid (essential building blocks of protein) used in Animal Feeds

- Typical characteristics of industries with cartel

- Succeeded in doubling prices between 1981-88

The Lysine Cartel

TOP LEVEL MEETINGS (Company Executives)

- Examination of recent market conditions
- Price Fixing region by region, country by country
- Product/Sales volume adjustment for each company
- Price Increase Schedule

FOLLOW UP MEETINGS

- Clarify situation after top level meetings
- Plan next meeting

REGIONAL MEETINGS

- Implementation

TRADE UNION MEETINGS USED AS COVER

FBI Secret Filming of Lysine Cartel

Senior Company Executives at cartel meeting:

1. Joking about getting caught
2. Fixing Prices
3. Allocating Sales Quotas
4. Reporting / Monitoring Production Levels
5. Incentive scheme to discourage cheating
6. Threatening Members thinking of Cheating

What happened to them?

MICHAEL ANDREAS

Executive Vice President, Archer Daniels Midland Ltd

&

TERRANCE WILSON

Group Vice President, Archer Daniels Midland Ltd

"We're not going to be manipulated by these God damn customers"

2 years in prison and $350,000 fine

Price-Fixing of Replica Football Kits

Matt Olczak

ESRC Centre for Competition Policy

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Background to the Case

- August 2000 UK Office of Fair Trading (OFT) received complaint from retailer – price fixing increasingly frequent & included a large number of retailers & brands
- OFT survey finds evidence of almost identical prices across retail outlets for England home shirt
- Umbro used Recommended Retail Prices (RRPs) suggesting these were essential to maintain the brand image
- OFT concluded RRPs used as focal points for price fixing behaviour

The Price-Fixing Agreement

- Price fixing agreements discovered both between:
  - Umbro & main retailers e.g. JJB; and
  - between the retailers themselves
- Pressure exerted both by Umbro on retailers and by retailers on Umbro to discipline rival retailers
- Agreements fixed prices of major Umbro replica shirts during crucial selling periods
- Often refusal to supply used to enforce the agreements
- Agreements enforced by informal meetings and the frequent monitoring of retail prices

Examples of Illegal Communication

- OFT evidence obtained by dawn raids on firms' offices, based on emails, letters, meeting notes etc
- Quotes from OFT (2003) case report:

"As we discussed, there is an argument for not offering any kind of discount on the England kit, because fans are likely to buy it even without a discount"

~ Internal FA email

"We are opposed to discounting as a matter of policy – what you are allowing to happen to your product is not in the best interests of your product"

~ Letter from Allsports to Umbro

~ Fax from Umbro to MU referred to assurances that rival firms would:

"…revise their current pricing of jerseys to reflect a price point that falls in line with market conditions"

Fines Imposed

COMPANY	FINES £m
JJB	6.3
Umbro	5.3
Manchester United	1.5
Allsports	1.42
Others	0.61
TOTAL	15.13

Effect on Prices

- OFT found that the England home shirt:
  - Before investigation = almost always £40
  - After investigation = £24-40
- UEA 2004 survey of England, Chelsea and Man Utd shirt prices found:
  - Min = £24; Max = £40; Avg. = £32-36
- Therefore, significant discounts on previous RRPs can now be obtained and consumers can benefit from searching across retail outlets

break

Some Contemporary Cases

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Some Contemporary Cases

- Private Schools
- Universities
- Televising Professional Football
- Credit Cards

- These illustrate that ‘talking’ takes many different forms, and isn’t necessarily always bad

Private Schools

- The Office of Fair Trading (OFT) recently investigated an agreement between fifty independent schools to exchange information about intended fee levels 2001-2004.
  - Information sharing is potentially an infringement of Chapter 1 of the Competition Act
  - Independent schools are covered by this act
  - Competition between schools supposed to keep fees down
  - Sharing information can reduce downward pressure on fees

The Resolution

- An agreed resolution negotiated between OFT and the schools was accepted in May 2006:
  - Schools admitted that the exchange of sensitive information involved a distortion of competition and infringed competition law
  - Each School to pay £10,000 in fines and together make a charitable contribution of £3m
  - The schools did not make any admission that the agreement had any effect upon fees

The Source

The investigation was reportedly started by a student who hacked into his school's financial records and leaked the documents to the press.

~ The Guardian, November 10, 2005

- Lessons
  - Don't talk
    - Because
      - You do not know who might hear you
      - You may leave a trace

Guidelines for the Future

- The OFT offered advice on the exchange of information [OFT444]:
    - The exchange of information on current or prospective fee increases may directly affect and reduce or eliminate competition between schools, and is likely to infringe the CA98
    - Even informal conversations between governors, heads or bursars that touch indirectly on future fee levels should be avoided
    - Care must be taken when "sharing best practices"
        - In particular it is advisable to exercise caution when discussing quantitative issues

University Top-Up Fees

- Imagine that Universities had been allowed to set tuition fees at whatever level they liked.
- Difficult problem as:
  - No tradition of doing this
  - Successful recruiting would depend on the fees charged by rival institutions
  - How can you know what others are charging?
- Lesson from *independent schools* case
  - Don’t talk about it

Do You Need to Talk?

- Government set a maximum for the top-up fee universities could charge:
  - Such a focal point can help “firms” select a fee even if they cannot speak to each other
- Unintended consequence?
- But not illegal for all to set the same fee
  - But providing a focal point can potentially stifle competition among universities with respect to the level of top-up fees

What Happened

- Most universities announced that they would charge the maximum top-up fee of £3,000

- Explanations
  - Most universities would in any case have charged more if free
  - Competition blunted by the focal point

Temptations

- What if there is heavy competition for students in clearing?
  - In the past competition has been on A-level requirements (affects league tables)
  - The existence of top-up fees adds a new dimension for competition
  - Tempting to reduce the top-up fees (or increase bursaries)
  - Competition on fee levels reintroduced?

OFFA to the Rescue

"Offering places at 'discounted prices' to fill course vacancies would be a risky approach" warns Office for Fair Access (OFFA)

press release 25 May 06

- Danger that this statement can help coordination between universities in terms of how to behave in clearing

Why Say it?

- Sir Martin Harris, Director of OFFA:

"The overall purpose of additional fees was to increase the resources available to institutions."

  - The extra revenue is for a good cause

- Equity between students
  - Last-minute discounts are unfair (think low-price airlines)

So…?

- Even in areas which we might not think are covered by competition law, talking about prices would be a violation
- In meetings with rival institutions there are issues which should not be discussed
- Sometime the answer is obvious so no need to talk
- There are arguments in favour of price-fixing
  - The funds raised from this are needed for a "good" purpose
  - May ensure that all pay the same price <u>and</u> this is fair

Televising Rights for Live Professional Football in England

The Background

- The top 20 clubs in England act as a single entity, the "Premiership", when selling the rights to televise their matches to TV broadcasters (Sky, BBC etc)
- Once the rights have been sold, and a contract signed, the broadcaster has exclusive rights to broadcast the matches

Restricts Competition in Two Ways:

- *No competition between broadcasters, except when bidding for the contract*
- **No competition between clubs in offering their matches to broadcasters**
- **European Commission has long kept a watching eye and has insisted on certain conditions before agreeing to the most recent bout of negotiations**

The Case Against the Premiership

- It is a 'joint selling agency', similar to a cartel, and, like a monopolist, it restricts quantity and pushes up price (per match)
- If clubs were allowed to sell their matches separately, more would be shown, price would be lower.

  Consumers would gain
- Also, existing contracts have a certain degree of built-in equality: income shared more equally than it would be if consumer allowed to choose which matches would be shown. Clubs like Arsenal, Liverpool, Man Utd lose out to Wigan, Blackburn etc.

In Defence of the Premiership

- Conventional economic arguments: e.g. reductions in transactions costs

But mainly:

- Football is an unusual product - only valuable if real competition. Joint selling protects the small, and although the big lose out in the short-run, it is also important to them that the small clubs survive. If not, competition would be diminished, and no-one would watch
- So different from, say, Tesco vs Sainsbury vs Asda

Credit Card Interchange Fees

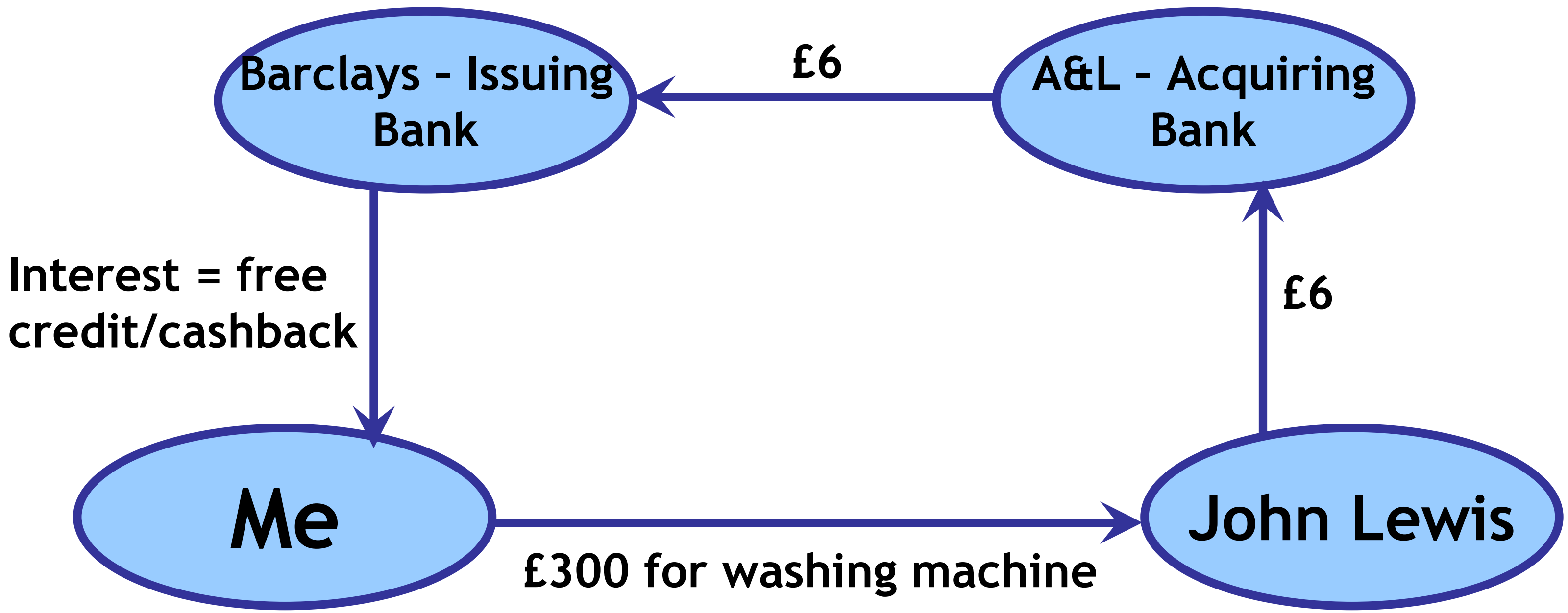
- Mastercard (and Visa)* are each effectively an association of banks. They operate networks involving consumers (cardholders) on one side, and merchants (shops etc) on the other

- Mastercard sets what is known as the Interchange Fee (IF) – a standard fee charged by all issuing banks to all acquiring banks (1.5-2%). So, in effect, the banks come to an agreement amongst themselves on the price

* *Hereafter, I refer to Mastercard for brevity, but all I say would apply equally to Visa. Similarly, although I use specific named banks as examples, the same applies to ALL banks.*

A Diagram to Illustrate

- I buy a washing machine for £300 using a Barclaycard MC from John Lewis, who deal with an acquiring bank, say A&L



Restricts Competition in Two Ways

- In principle, Barclays and A&L could agree an interchange fee between themselves
  - Say it is 2% - then A&L pay Barclays £6
- But, say Lloyds bank are willing to accept only 1% for its credit card transactions:
  - John Lewis would prefer to accept payments using a Lloyds card
- Competition between the banks might drive down the interchange fee

Competition Authority Interest

- OFT in the UK, European Commission in Europe, and many other authorities around the world have tried to restrict the banks in various ways

The Case Against Mastercard

- They have the power to set IF as high as they like. This will mean the acquiring banks will charge the shops more
- The shops won’t be able to resist – if they don’t take cards, shoppers will shop elsewhere
- Anyway, given that all shops have to pay, they can all pass on the fee to the consumer in the form of **higher prices**

The Case in Favour of Mastercard

- What's the alternative? Every issuing bank to negotiate a contract with every acquiring bank? Remember the 'honour all cards' rule
- Anyway, even if retail prices do rise, it doesn't matter. If the issuing banks do receive higher IF, they will indirectly pass this back to cardholders in the form of interest-free credit and cashback schemes, etc.
- Why? Because as the IF goes up, there is intense competition between banks to get new customers (think of all the mailshots you get)

My Worry With This Defence

- What happens, as prices go up, to those consumers who don’t use cards?
- Or those who do, but who don’t benefit from interest-free credit because they don’t clear their balance at the end of each month?