IN THE COMPETITION APPEAL TRIBUNAL

Cases No: 1160-1164/1/1/10

BETWEEN:

(1) IMPERIAL TOBACCO GROUP PLC
(2) IMPERIAL TOBACCO LIMITED

Appellants

- v -

OFFICE OF FAIR TRADING

Respondent

CO-OPERATIVE GROUP LIMITED

Appellant

- v -

OFFICE OF FAIR TRADING

Respondent

WM MORRISON SUPERMARKETS PLC

Appellant

- v -

OFFICE OF FAIR TRADING

Respondent

(1) SAFEWAY STORES LIMITED
(2) SAFEWAY LIMITED

Appellants

- v -

OFFICE OF FAIR TRADING

Respondent

(1) ASDA STORES LIMITED
(2) ASDA GROUP LIMITED
(3) WAL-MART STORES (UK) LIMITED
(4) BROADSTREET GREAT WILSON EUROPE LIMITED

Appellants

- v -

OFFICE OF FAIR TRADING

Respondent

ORDER (EXPERTS REPORTS)

UPON reading the submissions of the parties filed in advance of a case management conference on 26th May 2011

AND UPON hearing the parties' legal representatives at the case management conference on that date

AND UPON considering the Order made by the Tribunal in these appeals on 8th April 2011 ("the 8th April Order") setting out a timetable for the conduct of these appeals

IT IS ORDERED THAT:

1. The date fixed in paragraph 4 of the 8th April Order for the filing of the joint statements by the parties' experts be extended as follows:

    a. The statement concerning the matters raised in the reports of Dr Mike Walker to be filed on 5 pm on Friday 27th May 2011

    b. The statements in respect of the issues concerning the Respondent's theory of harm to be filed by 5 pm on Thursday 2nd June 2011.

2. As regards the joint statements referred to in paragraph 1(b) above:

    a. The statements shall be in the form of the list of issues attached to this Order;

    b. Each expert shall send by email to Mr Ridyard of RBB Economics his or her draft answer to be incorporated into each of the comments boxes on both parts of the list by noon on Monday 30th May 2011;

    c. Mr Ridyard will circulate to each expert by email the completed versions of both parts of the list as soon as possible on Monday 30th May 2011 following receipt of the answers;

    d. Each expert shall send by email to Mr Ridyard the final version of his or her answer to be incorporated into each of the comments boxes on both parts of the list by 10am on Thursday 2nd June or else indicate that there is no change from the version as circulated on 30th May 2011.

3. The timetable for the further conduct of the proceedings as set out in the 8th April Order is revised as follows:

    a. The date in paragraph 9 for the service by ITL of the joint bundle of authorities is extended to 5pm on Monday 4th July 2011;

    b. The date in paragraph 12(a) for the service by ITL of its skeleton argument is extended to noon on Thursday 9th June 2011;

    c. The date in paragraph 12(c) for the service by the OFT of its skeleton argument is extended to noon on Monday 4th July 2011;

    d. The date in paragraph 13 for the provision of electronic versions of documents is extended to 5 pm on Monday 4th July 2011

4. Liberty to apply.

Vivien Rose
Chairman of the Competition Appeal Tribunal

Made: 26 May 2011
Drawn: 26 May 2011

TOBACCO APPEALS

SCHEDULE TO THE TRIBUNAL'S ORDER OF 26 MAY 2011

PART 1

1. Basic structure of P&Ds

a. Shaffer's interpretation of P&Ds is that the agreements were about relative prices (e.g., he interprets a parity requirement as $P1=P2$, and a relative maxima as $P1 \leq P2$) ("Shaffer's price parity interpretation").

Clarification:

GS	
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b. Appellants' Experts' interpretation of P&D's is that the agreements were about relative markups (e.g., they interpret a parity requirement $P1\text{-}W1 = P2\text{-}W2$), and a relative maxima as $P1\text{-}W1 \leq P2\text{-}W2$).

Clarification:

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2. Incentives

a. Under Shaffer's price parity interpretation of the P&Ds

i Manufacturers have incentives to offer P&Ds.

Clarification:

GS	
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HJ	
GY/CD	
ND	

ii Retailers have incentives to accept P&Ds.

Clarification:

GS	
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HJ	
GY/CD	
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b. Under Appellants' Experts' margin parity interpretation of the P&Ds

i Manufacturers have incentives to offer P&Ds.

Clarification:

GS	
DR	
LF	
HJ	
GY/CD	
ND	

ii Retailers have incentives to accept P&Ds.

Clarification:

GS	
DR	
LF	

HJ	
GY/CD	
ND	

3. Pass-through

a. The existence of means by which 100% pass through of wholesale price changes to retail prices was obtained, including wholesale price changes contingent upon 100% pass through to retail prices, is consistent with Shaffer's interpretation of P&Ds.

Clarification:

GS	
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b. The existence of means by which 100% pass through of wholesale price changes to retail prices was obtained, including wholesale price changes contingent upon 100% pass through to retail prices, is consistent with Appellants' Experts' interpretation of P&Ds.

Clarification:

GS	
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4. Predictions

a. Retail prices

i Under Shaffer's interpretation of the P&Ds, retail prices would be expected to be higher with P&Ds than in the absence of the P&Ds.

Clarification:

GS	
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ii Under Appellants' Experts' interpretation of the P&Ds, retail prices would be expected to be lower with P&Ds than in the absence of the P&Ds.

Clarification:

GS	
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HJ	
GY/CD	
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b. Other factors

i Based on Shaffer's interpretation of the P&D agreements, the agreements would be expected to increase retail prices regardless of:

a. the distribution of bargaining power among manufacturers and retailers

b. whether lump-sum payments are or are not feasible

GS	
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c. whether the agreements specify parities or relative maxima

GS	
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HJ	
GY/CD	
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d. the number of retailers that have such agreements

GS	
DR	
LF	
HJ	
GY/CD	
ND	

e. whether retailers have agreements with one or both manufacturers

GS	
DR	
LF	
HJ	
GY/CD	
ND	

f. whether there was uncertain compliance because

i retailers may inadvertently have made mistakes

ii retailers may have decided not to comply in some instances

iii the agreements contained opportunity to respond clauses

GS	
DR	
LF	
HJ	
GY/CD	
ND	

ii Based on Appellants' Experts' interpretation of the P&D agreements, the agreements would be expected to decrease retail prices regardless of:

a. the distribution of bargaining power among manufacturers and retailers

b. whether lump-sum payments are or are not feasible

GS	
DR	
LF	
HJ	
GY/CD	
ND	

c. whether the agreements specify parities or relative maxima

GS	
DR	
LF	
HJ	
GY/CD	
ND	

d. the number of retailers that have such agreements

GS	
DR	
LF	
HJ	
GY/CD	
ND	

e. whether retailers have agreements with one or both manufacturers

GS	
DR	
LF	
HJ	
GY/CD	
ND	

f. whether there was uncertain compliance because

i retailers may inadvertently have made mistakes

ii retailers may have decided not to comply in some instances

iii the agreements contained opportunity to respond clauses

GS	
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HJ	
GY/CD	
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c. Unilateral wholesale price changes

i Under Shaffer's interpretation of the P&Ds, the retail price of the rival product would be expected to increase under a unilateral wholesale price increase.

Clarification:

GS	
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HJ	
GY/CD	
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ii Under Appellants' Experts' interpretation of the P&Ds, the retail price of the rival product would be expected to decrease under a unilateral wholesale price increase.

Clarification:

GS	
DR	
LF	
HJ	
GY/CD	
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d. Lump sum payments

i Lump sum payments, if any, flow to retailers in Shaffer's interpretation of P&Ds.

Clarification:

GS	
DR	
LF	

HJ	
GY/CD	
ND	

ii Lump sum payments, if any, flow to manufacturers in Appellants' Experts' interpretation of P&Ds.

Clarification:

GS	
DR	
LF	
HJ	
GY/CD	
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PART 2

1. Key assumptions underlying GS's static theory of harm

The following propositions set out the Appellants' Experts' understanding of the assumptions adopted by Professor Shaffer in his 2010 report.

1.1. Where the relative retail prices of brands A and B are linked in P&Ds, if the differentials in the P&Ds were fixed GS's static theory of harm assumes there is an obligation upon each Retailer to increase and/or decrease the retail prices of brands A and B in parallel following any increase and/or decrease in the wholesale price of Manufacturer A or B

As set out in Shaffer 82 to 116, the operation of the mechanism is that if a retailer increases/decreases the retail price of one product, it must increase/decrease the retail price of the rival, matched, product. GS's theory of harm envisages four scenarios, as follows:

i. **If the wholesale price of A increases, and the Retailer chooses to increase the retail price of A, then the Retailer is also obliged to increase the retail price of B by the same amount;**

ii. **If the wholesale price of A falls, and the Retailer chooses to reduce the retail price of A, then the Retailer is also obliged to reduce the retail price of B by the same amount;**

iii. **If the wholesale price of B increases, and the Retailer chooses to increase the retail price of B, then the Retailer is also obliged to increase the retail price of A by the same amount; and**

iv. **If the wholesale price of B falls, and the Retailer chooses to reduce the retail price of B, then the Retailer is also obliged to reduce the retail price of A by the same amount.**

Clarification:

GS	
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1.2. Where the relative retail prices of brands A and B are linked in P&Ds, but the differentials in the P&D of Manufacturer A operated as maxima, it is assumed that a single Manufacturer's P&D would bind only in scenarios (i) and (iv) of point 1.1 above.

Clarification:

GS	
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1.3. In the case of maximum price differentials, parallel P&Ds can have the effect of complementing each other so as to produce equivalent effects to fixed parities and differential requirements.

Clarification:

GS	
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GY/CD	
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1.4. Operation and relevance of "opportunity to respond" clauses found in trading agreements

GS's static theory of harm assumes that, where opportunity to respond clauses apply between the Retailer and Manufacturer A, they would operate such that the Retailer would be obliged to inform Manufacturer A prior to implementing either an increase or a decrease in the retail price of product B, with the consequence that if Manufacturer A chooses not to respond to the change in the retail price of product B then the retail price differentials between A and B will diverge.

Clarification:

GS	
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2. GS's 2007 mathematical model and Appellant Experts' adaptations of that model

2.1. A mathematical model was presented by GS (2007) and versions or variations of this same model have been presented by some of the Appellants' Experts (LF, ND, GY/CD and HJ, all in 2011).

Clarification:

GS	
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2.2. Where the Experts have produced mathematically-derived results, no Expert is aware of any flaws in any of the mathematical derivations.

Clarification:

GS	
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2.3. Within Shaffer's 2007 analytical framework, retailer compliance with P&Ds of x% (where x is less than 100) will result in less than x% of the price effect that would arise under full compliance

Clarification:

GS	
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2.4. Shaffer's 2007 model assumes that manufacturers have all the bargaining power.

Clarification:

GS	
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GY/CD	
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2.5. Shaffer's 2010 report does not contain a full set of explicit assumptions or any mathematically derived results; in this latter respect, it differs from his 2007 report.

Clarification:

GS	
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GY/CD	
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3. Incentives of the parties to reach P&D agreements

3.1. There are inherent incentive conflicts in Manufacturer-Retailer relationships

Clarification:

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3.2. Manufacturers have incentives to influence Retailer prices

Clarification:

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GY/CD	
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3.3. P&Ds need to be mutually beneficial in order to be agreed upon by both the Manufacturer and the Retailer

Clarification:

GS	
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HJ	
GY/CD	
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3.4. Retailer and manufacturer joint profits are relevant in determining whether retailers have an incentive to accept P&D agreements. In particular, the effect of P&Ds on retailers and manufacturers' joint profits affects the ability of manufacturers to make side payments to the retailers to incentivise the retailers to accept the P&Ds.

Clarification:

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3.5. Under GS' static theory of harm, there would be a need for payment of Retailer compensation

Clarification:

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GY/CD	
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3.6. Double marginalisation applies whenever there are positive price-cost margins at both the upstream and downstream levels

Clarification:

GS	
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3.7. P&Ds can help better to align retailer and manufacturer incentives

Clarification:

GS	
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4. The nature of P&Ds

4.1. The trading agreements included the offer of an incentive payment by the Manufacturer in return for the retailer providing marketing support for the Manufacturer's product including, *inter alia*, relative price positioning (i.e. P&Ds)

Clarification:

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4.2. Shaffer has not conducted any independent economic investigation to verify the form the P&Ds took

Clarification:

GS	
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LF	
HJ	
GY/CD	

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4.3. Under the margin parity interpretation regarding the way in which P&Ds operated, the degree to which the retail price of Manufacturer A's product responds to changes in the wholesale price charged by Manufacturer A is higher under the scenario with P&Ds compared to the scenario without them

Clarification:

GS	
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4.4. The alternative (i.e. margin parity) characterization of the agreements is consistent with paragraph 51 of Shaffer's 2007 advisory report. In other words margin parity P&Ds operate such that retailers are not "required to maintain the parity and differentials as specified in their trading arrangements, regardless of any disparities in each retailers' wholesale prices."

Clarification:

GS	
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LF	

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4.5. When P&D incentive payments were paid on a per stick basis (i.e. the size of the incentive payment increased as the Retailer bought more of the product), they would reduce the wholesale price and could not therefore be compensatory side payments

Clarification:

GS	
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4.6. Shaffer's analytical framework does not allow for the incentivisation of retailers to participate in P&Ds that take the form of a per stick discount

Clarification:

GS	
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GY/CD	
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4.7. The value of P&D incentive payments was small

Clarification:

GS	
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GY/CD	
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4.8. During the relevant period, the relative retail prices of paired brands did not remain fixed in the face of a unilateral wholesale price change for one of the brands

Clarification:

GS	
DR	
LF	
HJ	

GY/CD	
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4.9. Tactical bonuses gave a temporary wholesale price reduction to a Retailer, contingent on that Retailer reducing its retail price on a specified brand or brands, thereby leading to lower retail prices. The use of tactical bonuses undermines the proposition that the relative retail prices of competing brands were fixed by the existence of price parity P&Ds.

Clarification:

GS	
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ND	

4.10. ITL and Gallaher's P&Ds were not parallel nor symmetric

Clarification:

GS	
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5. Criteria for discriminating between the Experts' different views/assumptions on how the P&Ds operated

5.1. Under the price parity interpretation of P&Ds a unilateral increase in the wholesale price of one product would lead to an increase in the retail price of the rival Manufacturer's product. Under the margin parity interpretation of P&Ds, a unilateral increase in the wholesale price of one product would not necessarily lead to an increase in the retail price of the rival Manufacturer's product

Clarification:

GS	
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5.2. The evidence on the operation of P&Ds is inconsistent with the assumption that Retailers adhered to P&Ds causing them to move relative retail prices in parallel

Clarification:

GS	
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6. Predictions arising from GS's theory of harm

6.1. **If the operation of the P&Ds was such as to satisfy GS's static theory of harm, a number of empirically observable and testable outcomes might be anticipated. These include:**

a) Higher manufacturer wholesale prices

b) Lower sales volumes

c) Higher retailer gross margins (taking all aspects of remuneration into account)

d) Higher manufacturer wholesale prices to participating retailers than to non-participating retailers

e) Loss of retail market share from participating retailers to non-participating retailers

Clarification:

GS	
DR	
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7. GS's dynamic effects concerns

7.1. GS's 2010 Report mentions a dynamic theory of harm. GS's references to dynamic effects (GS 178 – 201) do not relate to theories of tacit collusion between manufacturers in which higher price levels could be sustained only by the existence of a mechanism that met the typical coordinated effects conditions of stability, transparency, enforcement/punishment mechanisms etc.

Clarification:

GS	
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8. Non-price marketing

8.1. Shaffer's 2007 model assumes that there is no non-price marketing even though non-price marketing may be an important determinant in sales of a retailer's sales of tobacco products.

Clarification:

GS	
DR	
LF	
HJ	
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