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IN THE COMPETITION

APPEAL TRIBUNAL

Case No. 1160-65/1/1/10

Victoria House,
Bloomsbury Place,
London WC1A 2EB

23 September 2011

Before:

VIVIEN ROSE
(Chairman)
DR ADAM SCOTT OBE TD
DAVID SUMMERS OBE

Sitting as a Tribunal in England and Wales

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 SUPERMARKET 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

**(1) SHELL UK LIMITED
(2) SHELL UK OIL PRODUCTS LIMITED
(3) SHELL HOLDINGS (UK) LIMITED**

Appellants

– v –

OFFICE OF FAIR TRADING

Respondent

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HEARING (DAY 1)

Note: Excisions in this transcript marked “[...][C]” relate to passages excluded.

APPEARANCES

Mr Mark Howard QC, Mr Mark Brealey QC and Mr Tony Singla (instructed by Ashurst LLP) appeared on behalf of the Appellants Imperial Tobacco Group Plc and Imperial Tobacco Ltd.

Mr Rhodri Thompson QC and Mr Christopher Brown (instructed by Burges Salmon LLP) appeared on behalf of the Appellant Co-operative Group Ltd.

Mr Pushpinder Saini QC and Mr Tristan Jones (instructed by Hogan Lovells International LLP) appeared on behalf of the Appellants WM Morrison Supermarkets Plc and Safeway Stores Ltd and Safeway Ltd.

Mr James Flynn QC and Mr Robert O'Donoghue (instructed by Norton Rose LLP) appeared on behalf of the Appellants Asda Stores Ltd, Asda Group Ltd, Wal-Mart Stores (UK) Ltd and Broadstreet Great Wilson Europe Ltd.

Ms Dinah Rose QC and Mr Brian Kennelly (instructed by Baker & McKenzie LLP) appeared on behalf of the Appellants Shell U.K. Ltd, Shell U.K. Oil Products Ltd and Shell Holdings (U.K.) Ltd.

Mr Paul Lasok QC, Ms Elisa Holmes, Mr Rob Williams, Ms Anneliese Blackwood and Ms Ligia Osepciu (instructed by the General Counsel, Office of Fair Trading) appeared on behalf of the Respondent.

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1 Wednesday, 21 September 2011
 2 (10.00 am)
 3 **THE CHAIRMAN:** I have a few preliminary remarks, Mr Howard,
 4 thank you.
 5 Good morning, ladies and gentlemen. First of all,
 6 many thanks to everybody for the very helpful
 7 submissions that we received at the start of the summer
 8 from you all, and also many thanks to those who have set
 9 up the courtroom this morning. We have read much of the
 10 material in the core bundles over the summer, and so we
 11 are reasonably familiar with the issues and the factual
 12 background.
 13 Just a few housekeeping matters to deal with before
 14 we start. As regards the factual witnesses whose
 15 evidence we will start hearing on the 30th, you can
 16 assume that we will re-read the witness statements and
 17 any contemporaneous documents that are expressly covered
 18 by the witness in his or her statements, but it would be
 19 useful if you would let us know at the end of the
 20 previous day's proceedings if there are any particular
 21 paragraphs of the decision or other documents in the
 22 annexes that it would be helpful for us to read before
 23 the witness starts.
 24 Secondly, we are producing a glossary based on the
 25 one at the back of Imperial's notice of appeal. We will

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1 circulate a copy of where we have got to with that at
 2 the end of today's hearing, and it would be useful for
 3 someone to keep a running version of this by adding new
 4 terms to it as and when they arise, and that can be
 5 recirculated electronically as and when appropriate.
 6 On similar lines, I understand that Imperial has
 7 agreed to create a bundle of any documents that are
 8 handed up during the course of the hearing and provide
 9 an index for that.
 10 As regards documents which emanate from or involve
 11 the parties and contain their confidential information,
 12 we hope that all parties will be alert when they are
 13 preparing their cross-examination as to whether they
 14 need to seek the permission of the owner of any
 15 information before using the document in court, so that
 16 we don't have any delays to witnesses caused by that.
 17 On the matter of confidentiality, there has been
 18 an exchange of correspondence about setting up remote
 19 access to the transcript, and this morning I signed
 20 an order dealing with arrangements for those already in
 21 the confidentiality ring to have access to that.
 22 A related issue is one that arose in the Pay-TV
 23 case, namely whether people who are not in the
 24 confidentiality ring but who belong to the party which
 25 is the owner of the confidential information should be

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1 able to remain in court when that matter is being
 2 discussed. The advantage is clearly that the person can
 3 then give instructions, if needed; the disadvantage is
 4 that there is then a multiplication of editions of the
 5 day's transcript that need to be produced at the end of
 6 the day.
 7 If the parties are prepared to take responsibility
 8 for sorting that out, and making sure that confidential
 9 information isn't inadvertently disclosed, then we are
 10 happy to proceed on the basis that the person can remain
 11 in court, but perhaps you can give some thought to that.
 12 Of course we would appreciate having as much notice
 13 as possible of when the Tribunal is going to be asked to
 14 sit in camera, if that arises, and we assume that
 15 parties will group their cross-examination questions to
 16 minimise the number of times we have to clear the court.
 17 Finally, on the issue of confidentiality, can we
 18 please charge junior counsel in each team with making
 19 sure that they know who is sitting in their section and
 20 whether or not they are in the ring, and for ensuring
 21 that when we do sit in camera, only those who are within
 22 the ring remain.
 23 Turning to the experts' evidence, it would be fair
 24 to say that we have all read the primary reports of the
 25 experts dealing with the theory of harm. We are less

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1 familiar with the matters surrounding the earlier report
 2 of Professor Shaffer and with the material in the
 3 statement of Mr Walker and those who cover that aspect
 4 of the case.
 5 So with those preliminary matters out of the way, we
 6 are now ready to start. Mr Howard, I think we will take
 7 a ten-minute break part way through the morning at
 8 a time that is convenient to you.
 9 Opening submissions by MR HOWARD
 10 **MR HOWARD:** Of course. I will refrain from introducing
 11 everybody since I am sure you know who the parties
 12 represent.
 13 The UK tobacco market is highly taxed and highly
 14 regulated. The effect of that is, firstly, that tax
 15 forms a very significant part of the retail price of
 16 tobacco. For instance, in the time under question, in
 17 this case 2000 to 2003, when a packet of cigarettes cost
 18 approximately £4, some 80 per cent or so, £3.60
 19 approximately, went to the Treasury.
 20 Secondly, regulation increasingly prohibited
 21 advertising, resulting in a so-called "dark market". So
 22 manufacturers such as Imperial had very little
 23 opportunity to promote their products other than on
 24 price. Although price is therefore the principal means
 25 of competition, there are a number of difficulties that

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1 lay in the way of price competition. The first is that
2 Imperial can reduce the price of its products, that's
3 the wholesale price, and it did so, but it had no
4 assurance that the retailers would pass on the reduction
5 in the wholesale price to the consumers.

6 One of the reasons for that is that the retailers'
7 primary interest is to ensure that it is competitive
8 with its rivals. Beyond that it's a matter of
9 indifference to the retailer whether it sells brand A or
10 brand B, and indeed it may be in the interests of the
11 retailer to sell them both at the same price, increasing
12 its margin on the product bought by it at the lower
13 wholesale price.

14 So the issue for Imperial, against this background,
15 was: how could it compete by reducing the price of its
16 products, the wholesale price of its products, and
17 ensuring that the price cut was passed on to the
18 consumer?

19 The other important background to this case is that
20 it involves an unusually transparent market, in which
21 Imperial and Gallaher are the major players. The
22 transparency arises from the legal obligation to publish
23 RRP's. Historically in this market, the manufacturers
24 have operated rival brands that compete with a brand
25 manufactured by the other, so Imperial's Embassy brand

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1 has historically competed with or been pitched against
2 Gallaher's Benson & Hedges or B&H.

3 Due to the need to publish RRP's, the manufacturers
4 are able initially to indicate how they wish their
5 particular brand to compete with the rival brand. So
6 Imperial might seek to set the RRP -- the recommended
7 retail price -- of Embassy 3p below that of B&H. The
8 corollary to this is that the wholesale price of Embassy
9 would also be expected to be correspondingly less.

10 Now, retailers are of course not obliged to follow
11 the RRP's and the extent to which they generally seek to
12 price above or below the recommended retail price
13 depends upon their particular pricing strategy, both
14 nationally and locally.

15 However, what one would naturally expect, all other
16 things being equal, is that the differentials reflected
17 in lower wholesale prices and RRP's for Imperial products
18 would, whatever the retailers' strategy concerning RRP's,
19 those differentials would be reflected in the retail
20 shelf price.

21 The difficulty that arose in practice is that
22 Imperial found that, although its products might have
23 been sold to the retailer for less, the retailer in fact
24 discriminated adversely against Imperial vis-a-vis
25 Gallaher in that, by the time the products reached the

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1 shelves at the outlet level, Imperial's product was not
2 priced favourably. The result, of course, was that
3 Imperial was denied the greater sales that it
4 anticipated through its lower wholesale price and lower
5 RRP.

6 Accordingly, Imperial's strategy was to compete with
7 Gallaher and to compete by encouraging the retailer to
8 reflect Imperial's lower wholesale prices in the retail
9 prices. It did so by providing various incentives to
10 the retailers, including incentives designed to reward
11 the retailers if they did not discriminate against
12 Imperial. This was done by providing for a bonus if the
13 retailers priced Imperial's products at prices relative
14 to the competing Gallaher brand, which were no less
15 favourable than the relative price points which Imperial
16 had sought to establish and as usually reflected in the
17 RRP's.

18 These differential provisions lie at the heart of
19 the case. They were introduced by Imperial in
20 an attempt to encourage a situation where the lower
21 wholesale prices it provided to the retailers were
22 passed through to consumers. In other words, it was
23 an attempt to lower the shelf prices of its products.
24 This, on any view, we suggest, was a plainly
25 pro-competitive strategy, whether examined on

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1 a subjective or objective basis.

2 Now, Imperial's pro-competitive strategy was in fact
3 successful. It won market share from Gallaher during
4 the alleged infringement period. Moreover, as one might
5 expect, this price competition reduced prices. Shelf
6 prices rose more quickly after the end of the alleged
7 infringement period than during.

8 It was against this background that the OFT launched
9 its investigation. As you will see, notwithstanding the
10 length of the investigation, the OFT has had some
11 difficulty in articulating the nature of its complaint.
12 The allegations which the OFT has made have changed over
13 time.

14 In the statement of objections, the OFT alleged that
15 Imperial's differential provisions had both the object
16 and effect of preventing, restricting or distorting
17 competition on the basis that they constituted conduct
18 akin to RPM. The OFT also alleged that Imperial and
19 Gallaher had engaged in indirect exchange of future
20 retail pricing intentions.

21 In the decision, the OFT has abandoned its case of
22 anticompetitive effects. It has also abandoned the
23 allegation of conduct akin to RPM, and it has abandoned
24 the allegation of illegitimate indirect contents.

25 Instead, it puts its case solely on the basis of

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1 a unique object theory of harm. As is clear from
 2 paragraphs 11 to 12 of the OFT's skeleton, to which I'll
 3 return later, what the OFT is essentially alleging --
 4 and it doesn't shrink from this -- is that the
 5 differential provisions were akin to horizontal
 6 co-ordination between Imperial and Gallaher.

7 The theory of harm, as set out in the decision, is
 8 based on a particular assumption or allegation as to how
 9 the differential provisions operated. In particular, as
 10 is clear from the reports served by the OFT's expert,
 11 Professor Shaffer, the key assumption made by the OFT is
 12 that the differentials were implemented in what we would
 13 describe as a rigid manner. That is to say that they
 14 required the participating retailers always -- and
 15 I stress the word "always" -- to keep the relative
 16 retail prices of Imperial's and Gallaher's competing
 17 brands in a fixed relationship, notwithstanding any
 18 wholesale price changes by either manufacturer.

19 The result is, according to the OFT, that the
 20 retailer is prohibited from favouring the rival brand,
 21 notwithstanding a wholesale price cut by the rival
 22 manufacturer, or is required to increase one brand's
 23 price following an increase in the wholesale price by
 24 the rival manufacturer.

25 Put simply, the OFT's case is that the retailers

1 were obliged to at all times maintain a fixed
 2 relationship between the price of one brand and the
 3 other.

4 Now, undoubtedly these allegations have the
 5 attraction of simplicity. The difficulty is that they
 6 do not in fact bear any relationship to the true facts
 7 of this case. In fact, the use of what we described as
 8 relative maxima schedules, or RMSs, heralded a period of
 9 acute price competition between the manufacturers. The
 10 fact of such price competition entirely belies the OFT's
 11 case theory and theory of harm.

12 The differential provisions in the trading
 13 agreements were neither expressed to operate in the way
 14 alleged by the OFT and assumed by Professor Shaffer, nor
 15 were they implemented in such a way.

16 Indeed, if the OFT's assumption of rigidity were
 17 correct, then the retailers would have stood to have
 18 made significant losses by entering into the trading
 19 agreements. Indeed, that is now common ground between
 20 the experts, and represents a fundamental problem for
 21 the theory of harm.

22 At the time it adopted the decision, the OFT sought
 23 to circumvent this by making another false assumption,
 24 namely that the retailers to whom the decision is
 25 addressed had no bargaining power whatsoever, and

1 therefore could simply be coerced by Imperial into
 2 complying with its pricing strategy, even if that was
 3 contrary to their own interests.

4 Now, a feature of the trading agreements is they
 5 usually contain what is being described as
 6 an opportunity to respond clause. All that such clauses
 7 did was to provide that the incentive bonus provided by
 8 the agreement could be revisited by Imperial in the
 9 event that Gallaher had undercut it. ITL gave no
 10 commitment that it would match the price reduction, nor
 11 on the facts did it always do so. Moreover, it would
 12 have been entitled to seek to match a Gallaher price
 13 reduction in any event, whether or not one had included
 14 the opportunity to respond clause.

15 However, for present purposes, the key point that
 16 belies the OFT's case is that the opportunity to respond
 17 clauses underline the fact that the differentials were
 18 subject to change in the wholesale price. In other
 19 words, this of itself shows that the OFT's contention
 20 that the differentials operated always and automatically
 21 by obliging the retailer to move the price of the
 22 Imperial product in tandem with the Gallaher product,
 23 for example following a reduction in the wholesale price
 24 of the Gallaher product, was wholly without foundation.

25 Recognising that the very existence of the

1 opportunity to respond clause is in Imperial's trading
 2 agreements contradict the assumption of rigidity upon
 3 which the theory of harm was premised, the OFT has
 4 significantly modified and developed its case
 5 incrementally in the defence and in the 2010 report of
 6 Professor Shaffer, and then particularly more recently
 7 in Professor Shaffer's 2011 report and in his comments
 8 on the joint experts' statement. I'll have to show you
 9 how this is developed to see the shift.

10 The shift is from a case based upon a theory which,
 11 however extreme and implausible, could at least be
 12 understood to one that is so predicated upon tentative
 13 predictions of response and counter response that it's
 14 very difficult to follow.

15 As I've already explained, the original case was
 16 that the agreements required the retailers to act in
 17 a certain way, namely at all times to maintain the price
 18 differentials, come what may, whatever Gallaher or
 19 Imperial did.

20 This was said to be the agreement and it was this
 21 which was said to have the anticompetitive effect,
 22 because a rival manufacturer would be unable to shift
 23 relative prices in its favour. "Would be unable", those
 24 are the words Professor Shaffer uses at paragraph 17 of
 25 his first report.

1 Whilst the OFT continues to assert this highly
 2 unlikely agreement, it's now running what appears to be
 3 a backstop case where it contends that the RMSs in
 4 Imperial's trading agreements simply made it easier for
 5 Imperial to match price changes by Gallaher, and that
 6 therefore over time, because it was easier for Imperial
 7 to match price reductions by Gallaher, Gallaher's
 8 incentive to compete would be diminished.

9 Now, this tentative theory is advanced on the basis
 10 of observations of promotions and counter-promotions
 11 combined with unquantified and vague notions of
 12 increased uncertainty -- see the OFT's skeleton at
 13 paragraph 20 -- reductions of uncertainty -- their reply
 14 at paragraph 175 -- which in turn are suggested as being
 15 capable of giving rise to an increased incentive.

16 We suggest this is a truly bizarre basis for
 17 an object infringement culminating in a purported find
 18 of in excess of £100 million.

19 Firstly, it is most unclear what aspect of the
 20 agreement on this basis has an anticompetitive object
 21 when, on this analysis, the object of the agreement was
 22 self-evidently to allow Imperial to cut prices. As
 23 a sense check, any form of restriction upon the retailer
 24 is singularly lacking.

25 Secondly, Imperial's desire to undercut Gallaher,

1 and in particular to ensure that its wholesale price
 2 discounts are reflected in lower shelf prices for
 3 consumers, is self-evidently pro-competitive. Indeed,
 4 the central purpose of the conduct is for Imperial to
 5 fund shelf price reductions from its margins which the
 6 OFT accepts the retailers were themselves disinclined to
 7 fund.

8 Thirdly, whether or not a situation might arise over
 9 time in which both manufacturers decide that it is no
 10 longer in their interests to compete, and whether or not
 11 that situation is the result of the trading agreements
 12 or structural deficiencies in the market owing to the
 13 role of taxation, regulation and the degree of
 14 concentration, is something that plainly requires and
 15 affects analysis.

16 What is clear is that the allegation of an object
 17 infringement is wholly unfounded, let alone the basis
 18 for the whopping fine sought to be levied on Imperial.

19 With that introduction, what I am proposing to do is
 20 as follows: firstly I am proposing to explain further
 21 the background as to why Imperial introduced the
 22 provisions in the first place and how they operated.
 23 I am then going to look at a couple of examples of the
 24 trading agreements. We will obviously look more fully
 25 when we deal with each individual retailer at their

1 particular trading agreement. Then I am going to spend
 2 the bulk of the time addressing the developing theory of
 3 harm and the problems with it.

4 I hope that I will be able to complete that part of
 5 our submission during the course of the day, although
 6 it's possible we may run over into tomorrow. Mr Brealey
 7 is then going to address you particularly upon the
 8 correct approach to an object infringement as a matter
 9 of law and the debate between the parties as to that.
 10 If time allows, he will also address you on the
 11 exclusion order and exemption, but we will have to see
 12 how much time we have.

13 So with that introduction, I now turn to the
 14 background. You will have seen quite a lot of this.
 15 The differential provisions which lie at the heart of
 16 the case were first introduced by Imperial into the
 17 trading agreements in the 1990s. In his first witness
 18 statement, which I don't think we need to turn up at the
 19 moment but it's in core 3, tab 36 {C3 tab 36} Mr Good
 20 explains that following his appointment in 1990 as the
 21 manager responsible for Imperial's UK national account
 22 customers, he reviewed the shelf prices at which
 23 Imperial's brands were being sold by retailers. That
 24 review revealed that in many stores, the shelf prices
 25 were either more expensive or the same as the price of

1 the products of the competitors, despite the fact that
 2 the products were being sold at lower wholesale price
 3 and had a lower RRP.

4 In other words, a particular Imperial product would
 5 have a lower RRP than an equivalent Gallaher product,
 6 and Imperial would be providing retailers with large
 7 sums of margin support to fund reductions even below
 8 that RRP, but the retailers were still selling the
 9 Imperial on the shelves for an identical price to the
 10 Gallaher product, thereby earning greater margins on
 11 Imperial's product than on Gallaher's product. As
 12 a result, consumers were not receiving the benefits of
 13 the lower wholesale prices that were being offered by
 14 Imperial to the retailers, and consequently, Imperial
 15 was not increasing its sales of market share, despite
 16 the fact that it was supplying a product at lower cost
 17 price than Gallaher.

18 Mr Good gives a particular example by reference to
 19 Embassy No 1, which is the brand that was pitched
 20 against Benson & Hedges. The RRP of Embassy No 1 was 1p
 21 less than that of Benson & Hedges at the time. This
 22 reflected the fact that Benson & Hedges was regarded by
 23 consumers as being the superior brand, and of course we
 24 can all remember -- at least those of a certain age --
 25 the advertising that Gallaher had put into

1 Benson & Hedges, with the pyramids and all sorts of
2 other things. So they had established it as one of the
3 leading brands. So Imperial's strategy in respect of
4 Embassy No 1 was to offer a lower price so that it would
5 appeal to consumers as a better value product.

6 Unfortunately, what was actually happening in the
7 stores was that this price differential was not being
8 reflected by the retailers. So, for example, if
9 Benson & Hedges had an RRP of, say, £1, and was being
10 sold in the major supermarkets for, say, 90p, because
11 the major supermarkets would be pricing below RRP,
12 Embassy No 1 might have had an RRP of 99p, but was also
13 being sold by the major supermarkets for 90p; in other
14 words, the same price as of Benson & Hedges.

15 So this was creating a difficulty for Imperial in
16 trying to, through providing lower prices, gain market
17 share.

18 **THE CHAIRMAN:** You said a bit earlier that the problem was
19 that they were being sold at a lower wholesale price,
20 but did Imperial assume that there was a lower wholesale
21 price for Benson & Hedges because of the difference in
22 the RRP, or did they know the wholesale price at
23 which --

24 **MR HOWARD:** They inferred it, they would not actually know
25 the wholesale price, but because of the nature of this

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1 market, namely that a very large part of the price that
2 the consumer pays is tax, so that one can then work
3 back, once you take out the tax, you can work out what
4 the margins are that one knows from one's own setting
5 the RRP, what the margins are that the retailers are
6 expecting to earn on tobacco, so you can then work back
7 from the RRP to infer what the wholesale price is.

8 In other words, there isn't a different margin, at
9 least one would have no reason to expect that the
10 retailers would expect different margins according to
11 whether they were selling Benson & Hedges or Embassy, at
12 least at the first instance.

13 In fact in practice, that's the difficulty, that
14 they choose to, notwithstanding the fact that they are,
15 as Imperial would see it, getting their cigarettes at
16 a lower price than Gallaher, but they are then charging
17 a greater margin.

18 If your question is: does one actually know what the
19 wholesale price is, one can infer it but one doesn't
20 actually have it, it is not a published price, but the
21 RRP is published.

22 **THE CHAIRMAN:** No, it's just that you refer to the problem
23 as there being a lower wholesale price that was not
24 reflected in the ultimate shelf price that Mr Good
25 noticed but --

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1 **MR HOWARD:** You can infer the wholesale price from the RRP.

2 **THE CHAIRMAN:** I was just checking that that was ...

3 **MR HOWARD:** You have to remember the RRP is based upon the
4 manufacturer's understanding of what the retailers'
5 margins would be. Not only the retailers' margin,
6 obviously, their margins there as well.

7 **DR SCOTT:** What you are saying to us is that this was pure
8 inference, rather than something which you will base on
9 evidence?

10 **MR HOWARD:** Yes, that you can infer the wholesale price from
11 the retail price. You have to remember, I am going to
12 come back to it, there is a legal obligation on the
13 manufacturers to publish the RRP, and that is the basis
14 on which the tax was calculated, and so that's what's
15 unusual in this, not that there are no markets in which
16 there may be RRP's, but this is a market where there is
17 an absolute legal obligation on the various
18 manufacturers to publish, and the basis on which they
19 would be determining the RRP would include a calculation
20 of what they understand the margins are that the
21 retailers are looking for.

22 **DR SCOTT:** One other question related to the RRP's: earlier
23 on I think I heard you saying that the differentials in
24 the trading agreements were sometimes but not always
25 reflective of the RRP's.

19

1 **MR HOWARD:** That's right. Essentially they are reflective
2 of the RRP, but that didn't necessarily have to be so,
3 but that is essentially what they are designed to do.

4 **DR SCOTT:** Thank you.

5 **MR HOWARD:** We will come back to the question of whether the
6 differentials are fixed or maxima and that debate in
7 a moment.

8 This problem that Imperial faced was, as has been
9 explained in the expert report, symptomatic of
10 a conflict that exists between manufacturers and
11 retailers., in that, on the one hand, a manufacturer has
12 a clear interest in low retail prices for its brands,
13 particularly compared to its competitors, as a way to
14 increase sales. On the other hand, as I've already
15 said, retailers are largely indifferent as to which of
16 the manufacturers' brands are purchased by consumers,
17 provided the consumers buy from their outlets. So they
18 are less concerned with the relative retail price of one
19 brand against another, and more concerned with the way
20 in which the consumers perceive their general price
21 competitiveness on the sale of tobacco products relative
22 to their competitors.

23 The importance of course of tobacco products to most
24 of the retailers is that it's not a product that they
25 promote, they can't in fact advertise, but it is

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1 important as a means of attracting customer footfall
 2 into their stores and so as a means of selling other
 3 products.
 4 The conflict in the incentives is explained by
 5 Mr Ridyard in his first report in core volume 3 at
 6 tab 25. {C3 tab 25}
 7 Paragraph 43 explains:
 8 "Hence, whilst both manufacturers and retailers can
 9 be expected to take an interest in tobacco pricing and
 10 be responsive to price changes, the precise focus of
 11 this interest differs between the two groups. Each
 12 manufacturer will have a clear interest in low retail
 13 prices for its brand as a way to increase sales, with
 14 particular interest in how its brands are priced
 15 relative to those of rival brands in the store. Each
 16 retailer, in contrast, is likely to be less concerned
 17 with the relative price of one brand against another,
 18 and more concerned with the way in which consumers
 19 perceive its general price competitiveness on the sale
 20 of tobacco products relative to retailers in its
 21 immediate competitive set. As we discussed below, this
 22 difference in perception affects the way in which
 23 manufacturers such as ITL sought to incentivise
 24 retailers in the context of its trading agreements."
 25 We don't need to turn it up, but a similar point is

1 made in Professor Froeb's first report at paragraph 11,
 2 and the point is in fact echoed in Professor Shaffer's
 3 2010 report, which you will find in {core 6, tab 65 at
 4 page 44}, and again I don't think we need to take time
 5 up referring to that at the moment.
 6 Now, this problem was compounded by the next two
 7 particular features of the market. The first is the
 8 dark market, which, as we all know, the Government
 9 gradually, and perhaps with ever increasing rapidity,
 10 introduced various advertising restrictions over the
 11 last few decades.
 12 Since the Tobacco Advertising and Promotion Act of
 13 2002, there is a complete ban on billboard and press
 14 advertising. All that tobacco manufacturers are allowed
 15 to do is to place a single advert not exceeding A5 size
 16 at the point of sale. Thus, traditionally, tobacco
 17 manufacturers used to spend very large amounts of money
 18 promoting the visibility, image and brand values of
 19 their products, sponsoring sporting events and other
 20 such things. Now effectively that is all finished and
 21 we have the dark market.
 22 The restrictions on advertising are recognised by
 23 the OFT in the decision at paragraph 5.12 and explained
 24 by Mr Batty in his statement and Mr Cheyne. Mr Batty
 25 you will find in {C3, tab 33 at paragraphs 2.6 to 2.11},

1 and Mr Cheyne in {C3 tab 34 at paragraph 32}.
 2 Now, the absence of any advertising has the result
 3 that competition on price is particularly important, and
 4 again this is common ground, see the decision at
 5 paragraphs 6.256 and 8.64.
 6 Because price competition has become such a key
 7 feature of the market, and no doubt also because of the
 8 increased tax levy, making consumers more price
 9 conscious, there has been a development in growth of
 10 what's called the low price and the ultra low priced
 11 product categories. Again, they are explained by
 12 Mr Batty in his statement at 2.8 to 2.9.
 13 Mr Cheyne, it's perhaps worth turning up his
 14 statement at this point in core 3, where he explains the
 15 importance of the price competition. Mr Cheyne is
 16 a former consultant to both First Quench and Somerfield.
 17 His statement is to be found in {C3 at tab 34 at
 18 page 387}.
 19 Perhaps if you just glance at paragraph 32, he
 20 explains the emergence of the dark market, and then in
 21 paragraph 33, he explains that:
 22 "The manufacturers' strategies focused on making
 23 sure that their products were widely available in the
 24 market and were priced competitively. In order to
 25 achieve this, they sought to ensure that the retailers

1 stocked a wide range of product lines and that
 2 retailers' merchandising and displays were effective
 3 (which meant, for example, that each manufacturer
 4 preferred to have its own gantries in retail chains).
 5 In my view, the importance to the tobacco manufacturers
 6 of product availability and competitive pricing was
 7 based on a continuing concern that customers would
 8 ultimately switch to a competing brand if their usual or
 9 preferred brand was not available on the shelves or it
 10 was perceived as being poor value compared with a rival
 11 brand. In my experience, although many smokers remain
 12 loyal to their particular brands, the ever increasing
 13 levels of tax have meant that more and more consumers
 14 are willing to switch to better value brands,
 15 particularly in the lower price sectors, for example,
 16 Dorchester (a Gallaher brand) and Richmond (an ITL
 17 brand).
 18 "34. The perceived threat of switching, coupled
 19 with UL's aggressive growth strategy meant that
 20 competition between ITL and Gallaher was particularly
 21 vigorous, both in terms of the product service/mix
 22 offering and pricing."
 23 Now, the competition on price is particularly
 24 important given that those who smoke, and therefore
 25 purchase cigarettes, are spending a significant part of

1 their disposable income on cigarettes, or at least that
 2 would be the case for many people.
 3 So in order for Imperial to win market share from
 4 Gallaher, it was incumbent on it to devise a system of
 5 making its retail products more attractively priced in
 6 the stores relative to the price of Gallaher's products.
 7 The next point that's important in relation to all
 8 of this is that price competition in this market, at the
 9 consumer level, has to be driven by the manufacturers,
 10 because it is a feature of the market that firstly
 11 retailers are very unlikely to pass on wholesale price
 12 discounts to consumers themselves, and they are very
 13 unlikely independently to implement price reductions of
 14 their own initiative.
 15 This all comes out of the fact that there is a very
 16 high tax regime, tax could constitute 80 per cent or
 17 more of the retail price. As a result, tobacco products
 18 represent low margin products for the retailers. There
 19 are various estimates of what it is. Mr Batty, at
 20 {paragraph 2.23 of his statement in C3/33} estimates
 21 that the gross retail margin on factory made cigarettes
 22 products is as little as 5 per cent. Mr Cheyne
 23 estimates that on average for a retailer the margin is
 24 around 7 to 9 per cent on tobacco products, as to be
 25 contrasted with 25 to 45 per cent on other grocery

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1 products. Mr Cheyne is in {core 3, tab 34, page 382}.
 2 The effect of the low margins means that the
 3 retailers have little incentive to pass through
 4 wholesale price discounts which are being provided by
 5 the manufacturers. This is explained by Mr Ridyard at
 6 {C3, tab 25, page 93}.
 7 This is in a section of his reporting explaining
 8 that the essential motivation for the RMSs is
 9 pro-competitive. At {C3, tab 25, 234} he explains that:
 10 "In a setting where retailers' margins make up a
 11 very small element of the typical retail price (under 10
 12 per cent) both economic theory and observed market
 13 conduct predicts that retailers have muted incentives to
 14 pass through manufacturer wholesale price cuts or
 15 unconditional bonus payments in the form of lower
 16 prices. As discussed in Section 2 of this report, this
 17 arises from the fact that even a large cut in retailer
 18 remuneration will affect retail prices (and hence
 19 consumer demand) only marginally. Hence, the ability of
 20 manufacturers to make the payment of bonuses contingent
 21 on the retailer's performance of certain output
 22 -expanding activities is useful for the manufacturer."
 23 You can read to the end of that.
 24 Because of the low margins, the retailers themselves
 25 have very limited scope to implement profitable own

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1 account price reductions of their own initiative.
 2 Again, that is explained by Mr Cheyne at paragraphs 18
 3 to 19, but the best illustration of it is back in
 4 Mr Ridyard, if we could turn back, if you still have it
 5 open, at pages 19 to 20, where he graphically explains
 6 the position at paragraph 31:
 7 "As the Decision notes, tax can constitute 80 per
 8 cent or more of the retail price of a tobacco product.
 9 This means that manufacturer and retailer margins form a
 10 small proportion of consumer prices. Moreover, because
 11 the specific duty is fixed irrespective of the price of
 12 the product, and the ad valorem element is determined by
 13 the products RRP rather than actual selling price,
 14 neither the manufacturer nor retailer has the ability to
 15 exert a strong influence over consumer prices. For
 16 example, a supermarket in 2003 typically would have sold
 17 Lambert & Butler ("L & B") KS 20s for £3.98, of which
 18 the tax element would have been in the region of £3.52
 19 (88.5 %). Therefore, to achieve a 5% reduction in the
 20 consumer price, the price per pack excluding tax would
 21 need to fall from £0.46 to £0.26, which represents a
 22 reduction of 43% in the price excluding tax, assuming
 23 that the tax payable on the product would remain largely
 24 or completely unchanged. Since the supermarket
 25 retailer's gross margin on this product might typically

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1 have been around 5% or less of the retail price, it is
 2 easy to see that retailers in particular (since they
 3 exert no control over RRP) have very limited scope to
 4 initiate profitable own account price reductions."
 5 **MR SUMMERS:** Mr Howard, I wonder if I could ask for a little
 6 clarification. We are hearing a lot about low margins
 7 in the industry, it's very evident in the papers
 8 throughout, but we also know that there are off-invoice
 9 payments, there are bonuses, things described as central
 10 support. When we talk about low margins, or when these
 11 papers talk about low margins, are they talking about
 12 the margin before the application of these other forms
 13 of support to the price which is then offered?
 14 **MR HOWARD:** They are generally talking about the position
 15 after taking account of everything.
 16 **MR SUMMERS:** Everything?
 17 **MR HOWARD:** That's right. One of the things you have to
 18 bear in mind is the levels of support, particularly in
 19 relation to the RMS bonuses is very small indeed. What
 20 one is looking at generally is the overall position.
 21 **MR SUMMERS:** Because I am not an accountant, but I do
 22 understand that there are accounting issues relating to
 23 central support, and that in some companies that may be
 24 treated, as it were, as something that goes straight to
 25 the bottom line and in other cases it is applied

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1 directly back, as it were, to the product.
 2 **MR HOWARD:** I'll check precisely what the position is, but
 3 my understanding is that all or certainly most of what
 4 is being paid by way of support is basically margin
 5 support on the whole, and therefore it is, when one is
 6 determining what the margin of the retailer is, we have
 7 to look at the wholesale price plus any additional
 8 support that is obtained.

9 **MR SUMMERS:** Thank you.

10 **MR HOWARD:** Yes, I am told that's correct.

11 Now, while we are on the conduct of the retailers
 12 and their motivations, the retailers are also reluctant
 13 to be seen to be promoting tobacco products, because of
 14 the perceived risk of reputational damage. As explained
 15 in both Mr Good's and Mr Batty's statement, it is only
 16 really a statement of the obvious in the modern
 17 environment.

18 So price competition has to be driven by the
 19 manufacturers, and that the only circumstance in which
 20 the retailers, but it's an important circumstance in
 21 which they are interested in price competition is when
 22 they are benchmarking themselves, which is what they
 23 generally do, particularly the supermarket groups,
 24 against another supermarket. So Tesco, if Safeway or
 25 Morrisons or Asda is benchmarking itself against Tesco,

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1 if in fact Tesco's price for a particular product is
 2 low, then that is something obviously they seek to meet,
 3 but they are only going to be taking those initiatives
 4 insofar as it's driven by a competitor.

5 The role of RRPs, there is a legal obligation to
 6 publish RRPs, essentially because the tobacco
 7 manufacturers are required to pay different forms of
 8 tax, including ad valorem duty.

9 European law provides that the ad valorem duty must
 10 be calculated and paid by the manufacturer as
 11 a percentage of the final retail product, the final
 12 retail price. In some, and indeed many European
 13 countries, this is dealt with by the manufacturers being
 14 required to price mark the packaging of products with
 15 a price duty stamp which actually fixes the price at
 16 which the retailer must sell the product.

17 In the United Kingdom, that model hasn't been
 18 followed, and the retailers are free to set their own
 19 retail prices, but that freedom needs to be reconciled
 20 with the obligation of the manufacturers to pay
 21 ad valorem duty as a percentage of the final retail
 22 price.

23 So the RRPs are intended to reflect the spread of
 24 the selling prices around the market.

25 Now, the transparency of pricing which results from

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1 the publication of RRPs is a highly relevant feature of
 2 the industry in the UK, and can I ask you again to turn
 3 to Mr Ridyard's first report at {C3, tab 25, page 20},
 4 please. Paragraph 33 explains that:

5 "RRPs play a prominent role in the arrangements for
 6 calculating and implementing tax incidence for the
 7 industry. To avoid the administrative complexity of
 8 collecting ad valorem taxes based on actual transaction
 9 prices, the industry is permitted to calculate taxes on
 10 the basis of RRP, with the proviso that RRPs provide a
 11 reasonable proxy for actual prices overall. As we show
 12 below, actual retail prices are widely dispersed above
 13 and below RRPs depending on the type of retailer and its
 14 pricing strategy. However, the resulting requirement
 15 for the industry to publish RRPs imposes a degree of
 16 transparency on industry pricing that is different in
 17 kind from other consumer goods sectors. Whilst tobacco
 18 manufacturers engage in a variety of bonus arrangements
 19 and discounts from standard wholesale prices that are
 20 based around the RRP, this RRP -induced pricing
 21 transparency allows manufacturers to observe the pricing
 22 structures of their competitors in a way that is not
 23 apparent in other branded consumer good sectors.
 24 Clearly, this is a feature that exists in the industry
 25 irrespective of the existence of RMSs."

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1 **THE CHAIRMAN:** The RMSs?

2 **MR HOWARD:** Sorry, the RMSs. I want to show you another
 3 passage, but this is clearly a very important factor
 4 that one has to bear in mind in this case, the way in
 5 which this market operates in any event as a result of,
 6 for instance, the transparency created by publishing
 7 RRPs.

8 If you turn forward to tab 26, this is further
 9 explained by Mr Ridyard at page 149 of the bundle.
 10 Sorry, paragraph 149, page 157. {C3, tab 26, page 157}
 11 At paragraph 147 he refers to Mr Walker questioning what
 12 relevance can be attached to the fact that advertising
 13 of tobacco is highly regulated and the retail price
 14 contains a very high element of tax. He says that he
 15 explained in his first report that:

16 "... the existence of advertising restrictions gives
 17 tobacco suppliers fewer instruments with which to work
 18 when trying to sell their products and in my view, the
 19 inability of a manufacturer to negotiate with retailers
 20 over factors such as promotional slots, access to
 21 end-of-aisle displays etc is likely to accentuate the
 22 importance that suppliers place on prices and how its
 23 product is priced relative to its immediate rivals.
 24 This context helps to explain why ITL acted in a
 25 pro-competitive (i.e output-expanding) fashion when

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1 providing incentives to retailers to favour its brands
 2 over rival brands when negotiating agreements with
 3 retailers.
 4 "As regards the high tax burden on tobacco products,
 5 paras 31 -32 of DR1 explained how the tax arithmetic
 6 dulls the retailer's incentive to pass on a wholesale
 7 price reduction. That in turn again explains why
 8 retailers may be inherently unmotivated to initiate
 9 retail price competition in these products and provides
 10 useful context to explain why ITL sought to use RMSs
 11 (alongside other measures and incentives) to encourage
 12 retailers to cut retail prices when wholesale prices
 13 fell. In DR1 I mentioned a number of other factors
 14 concerning the regulation and public perception of
 15 tobacco products that could also explain why it would be
 16 additionally difficult to persuade retailers to
 17 participate in manufacturer initiatives to boost sales
 18 volumes of their brands.
 19 "The role of RRP's. Mr Walker refers to the comments
 20 in DR1 regarding the role of RRP's, and he contends that
 21 I did not explain why the transparency that arises from
 22 RRP's was relevant to the competitive assessment I
 23 appreciate that suppliers in a number of consumer goods
 24 markets publish RRP's, but the de facto legal requirement
 25 for tobacco manufacturers to do so does in my view make

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1 this industry distinctive, if not unique. This degree
 2 of transparency on manufacturer pricing is relevant to
 3 the competitive assessment because the inter-brand price
 4 transparency that arises through the requirement to
 5 publish RRP's, in conjunction with the frequent common
 6 cost shocks caused by taxation increases, provides a
 7 ready explanation for the degree of parallel pricing one
 8 observes in the industry that exists independently of
 9 the presence of RMSs. Specifically, in order to
 10 conclude that RMSs had the effect alleged by the OFT of
 11 securing increased parallel movement in inter-brand
 12 prices, it is important to distinguish this alleged
 13 effect clearly from the tendency for highly transparent
 14 RRP announcements to have a similar influence on price
 15 progression over time. Such considerations become
 16 acutely important when considering the so-called dynamic
 17 theories of coordinated pricing that are discussed in
 18 Section VI of GS.
 19 "For example, at paragraph 194 GS speculates on the
 20 possibility that manufacturers 'might' over time
 21 anticipate rivals' responses, and at paragraph 195, he
 22 further speculates that observation of rival suppliers'
 23 behaviour 'might' allow them to coordinate their
 24 wholesale pricing decisions. These are of course
 25 standard concerns in any theory of price coordination in

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1 a concentrated market with high transparency, but
 2 speculation as to whether such conduct might over time
 3 lead to price coordination is not the same as a
 4 conclusion that it is likely to do so. Experience with
 5 evaluating coordinated effects concerns in competition
 6 law investigations shows that this task requires a very
 7 fact-intensive inquiry into the way the industry
 8 operates and into the contribution that the alleged
 9 coordinating practice has on competitive conduct. It is
 10 therefore very far divorced from the inevitability of
 11 competitive concern that is required for an 'object'
 12 infringement.
 13 "Moreover, in the current context the enquiry into
 14 competition in this market is not a general 'fishing
 15 expedition' into conduct or characteristics that might
 16 lead to coordination, but a specific allegation that the
 17 RMSs were by their nature anti-competitive. If the
 18 publication of RRP's in this industry provides an
 19 independent route whereby manufacturers can learn about
 20 their rivals' pricing decisions over time, it becomes
 21 all the more difficult to establish that any dynamic
 22 concerns with manufacturer price collusion can be
 23 plausibly, let alone reliably, linked to the RMS."
 24 **DR SCOTT:** Mr Howard, can you pause at the moment on this
 25 issue of transparency?

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1 **MR HOWARD:** Yes.
 2 **DR SCOTT:** The RRP's are very straightforward, as
 3 I understand it. The wholesale pricing is a good deal
 4 more complex. It's complex, as I understand it, both in
 5 terms of QN, you have the different levels of
 6 discounting, in terms of bonusing, and in terms of
 7 differential pricing as between retailers, which we may
 8 learn more about but in particular they may be
 9 quantitative, they may be bonus related and so on, so
 10 that it seems that you may be able to infer something
 11 from the RRP's, but the thought that you can infer
 12 a great deal about the complexity that lies behind the
 13 RRP's in terms of wholesale pricing and its
 14 differentiation between retailers strikes me as a little
 15 far-fetched.
 16 **MR HOWARD:** Well, I am not sure what is far-fetched about
 17 it. One has to remember, for instance, the discounts
 18 that are available to the retailers are, for instance,
 19 there are volume discounts, the volume discounts are not
 20 likely to be different between one and the other.
 21 Most of the discounts which manufacturers are likely
 22 to offer in terms of things like volume are things which
 23 are reasonably well known.
 24 If you are saying: is it necessarily a precise
 25 relationship whereby you can say precisely what is the

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1 position?, you may be right, but you can infer -- we
2 will obviously have to hear evidence about it -- I would
3 suggest one can infer with a reasonable degree of
4 certainty where the position is, and not least because
5 of the low margins which everybody is aware are actually
6 available on these products.

7 **THE CHAIRMAN:** Will we be hearing from someone -- the
8 earlier passage that you took us to indicated that the
9 RRP's are derived from an analysis of the actual retail
10 selling prices observed in the market.

11 **MR HOWARD:** No, it is what you are anticipating is going to
12 be the spread, because of course when you set the RRP,
13 at that stage it's looking effectively to the future,
14 it's not -- it's what you anticipate will be the spread.

15 **THE CHAIRMAN:** It's just that some of the evidence that we
16 have seen indicates that the retailers set their prices
17 by saying a certain number above or below RRP. The
18 whole thing becomes circular.

19 **MR HOWARD:** The thing is it is a rather complicated exercise
20 in determining what, because of the different price
21 bands, different retailers have. So you have some
22 retailers which have -- I can't remember the number but
23 some have a vast number depending on the type of
24 different store you may have.

25 If one takes an obvious high street supermarket, the

1 ordinary supermarket, they have the petrol station
2 outlets, they have the convenience stores, to name just
3 three. Their pricing strategy will be different in each
4 of those outlets, so the convenience store they are
5 likely to charge above RRP because a premium can be
6 charged obviously for all goods on the basis that people
7 are being provided with them at convenient times
8 locally. Petrol stations the same.

9 **THE CHAIRMAN:** Is the method by which Imperial and Gallaher
10 arrive at their RRP's something set by or agreed with the
11 Revenue, or is that something entirely within their --

12 **MR HOWARD:** I'll have to check on that, exactly how that is
13 done, but my understanding is that each manufacturer is
14 not in a position, as it were, to adopt an idiosyncratic
15 method of determining the RRP. Ultimately, it's meant
16 to reflect, overall, the price at which the products are
17 being sold, and therefore tax is being accounted for.

18 You have to remember, what the manufacturer is doing
19 is just acting as a tax collecting agent for the
20 Revenue, the person who is supposed to be paying the tax
21 is the smoker.

22 **THE CHAIRMAN:** That was another factual question that you
23 may know the answer to, whether there is an obligation
24 on the manufacturer and on the retailer to pass through
25 tax increases that are imposed, given that part of the

1 reason for the tax increase may be to deter people from
2 smoking or whether it's possible, if only theoretically,
3 for one or other person in the chain to absorb some of
4 the tax increase.

5 **MR HOWARD:** That is what happens, they do, when there are
6 Budget increases, sometimes the prices are held at pre
7 Budget levels, and what is happening there is that the
8 manufacturer is absorbing the -- the tax is still being
9 paid by the consumer, but accounted for to the Revenue,
10 it's simply that the manufacturer is then cutting his
11 margin.

12 In other words, the law isn't saying that the
13 manufacturer has to charge the tax plus a particular
14 premium above to cover his margin. The manufacturer can
15 sell the cigarettes at a loss. But I don't think he can
16 sell below the tax price, but he doesn't have to charge
17 a margin on top so he could in theory absorb a large
18 loss. But that doesn't happen, what happens is that
19 there are Budget increases, and the manufacturer may see
20 this as a chance to gain customers by holding his
21 cigarettes at the pre Budget price, therefore making
22 them relatively cheaper and pays a bonus to do that, or
23 pays --

24 **THE CHAIRMAN:** You are talking there about something beyond
25 this practice of pre-buying and storing pre Budget --

1 **MR HOWARD:** You can have the cigarettes which are duty paid,
2 effectively, and are still being sold, but there is also
3 a practice of saying "We will hold the price for this
4 period of time, we will pay effectively for it".

5 **DR SCOTT:** Just going back for a moment, I suppose what you
6 are saying -- and I want to avoid using either the word
7 "parallel" or "similar" for reasons that we will come to
8 later in the case -- is that there was a sufficient
9 understanding by Imperial, presumably by Gallaher, of
10 the way in which things were done that you could infer
11 the way in which the structure of wholesale prices was
12 likely to be going on behind the changes in the RRP.

13 **MR HOWARD:** You have to remember, the point -- if I can just
14 go back to your question and how complicated is it, you
15 have to remember, first take out the tax element,
16 because you obviously can work out what the tax element
17 is from the RRP, it's straightforward, it's just
18 a calculation.

19 Then what are the cost prices, what are the cost to
20 the manufacturers. The costs to the manufacturers are
21 essentially the same in the sense that they are exposed
22 to the cost of obviously the product, tobacco, and then
23 you have manufacturing costs in the UK. Remember they
24 are both UK manufacturers with UK employees and the
25 costs that that involves. Then you have distribution

1 costs. Of course they are not precisely the same, one
2 may operate in a more efficient way than the other, but
3 they will know just from studying public documents
4 a fair amount about each other, so that -- and will also
5 know from the public documents what the margins are that
6 they are each seeking to earn. Then you know what the
7 RRP is.

8 From knowledge of the way in which the industry
9 operates, I would suggest it is not actually terribly
10 complicated to infer what the likely wholesale price is.
11 Of course then that's where the price competition comes
12 in as to whether one is offering greater incentives to
13 the other, but for instance if one again thinks about
14 it, between the main supermarkets it's highly unlikely
15 that Imperial or Gallaher is going to be able to offer
16 differential terms to the different supermarkets because
17 again they are looking at each other like hawks. So
18 that is, for instance, Sainsbury get some basis of
19 buying the cigarettes whereby it is able to price them
20 way below Tesco, Tesco is going to come along and say
21 "Well, this isn't satisfactory". You may not tell them
22 the precise terms but ultimately there is going to be
23 a fair amount of intelligence just from studying what is
24 objectively available.

25 It's the RRP's, though, which provide a particular

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1 increased amount of information. Because the RRP's are,
2 it's because of the involvement of the manufacturers
3 particularly which makes a difference.

4 Now --

5 **MR SUMMERS:** Sorry, Mr Howard. You said that the cigarettes
6 were UK manufactured?

7 **MR HOWARD:** Yes.

8 **MR SUMMERS:** Can you confirm that the cigarettes, all the
9 cigarettes, were actually UK manufactured? Because at
10 this point in time it's a matter of general knowledge
11 that certain companies did establish manufacturing
12 plants in Eastern Europe.

13 **MR HOWARD:** Yes.

14 **MR SUMMERS:** And I just wonder in fact whether some of the
15 Eastern European output fed into the UK therefore with
16 a different form of manufacturing cost.

17 **MR HOWARD:** I will check that, but let's assume that that in
18 part happens. Again, it will not affect things in that
19 each of the manufacturers will be aware of the extent to
20 which its rival, for instance, has set up a plant, let's
21 say Gallaher sets up a plant in Eastern Europe and
22 Imperial hasn't done it, so Gallaher is able to set its
23 prices lower because of the lower cost. Imperial will
24 know that, and so in setting its RRP's that it's trying
25 to undercut, it will be aware of the fact that

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1 Gallaher's wholesale price as a result of that might be
2 a lot less, and therefore its RRP might have to be
3 significantly less in order to allow the retailer to
4 make the margin that it anticipates.

5 You have to remember, what is happening when they
6 set the RRP is that they are taking account of what they
7 believe is the margin for the retailer. That's what's
8 unusual about it. They have to be involved in the
9 understanding of the retailer's margins.

10 Just to summarise this aspect, we have already seen
11 that tax is a major component of the retail price.
12 Secondly the obligation to publish RRP's which certainly
13 lead to, let's put it no higher than a high element of
14 the transparency in the marketplace at wholesale and
15 retail level.

16 The next point is that factors influencing the
17 wholesale price, particularly tax increases and also
18 probably the cost of production, are likely to affect
19 the manufacturers either to the same or to a very
20 similar degree, therefore the transparency, the
21 concentrated nature of the market and the extent of
22 exposure to common price factors does, as has been
23 explained in the expert evidence, provide a ready
24 explanation for a phenomenon then of parallel pricing
25 which one can observe in this industry, in any event,

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1 that is to say independently of the RMS's.

2 As Mr Ridyard points out, what this case is about
3 and has to be about is not whether the way in which this
4 market operates or the structure of the market is
5 satisfactory, it has to be about what effect, if any,
6 the RMS agreements have. One criticism that is fair to
7 make, we would suggest, of the OFT in its decision and
8 Professor Shaffer in his reports is the failure really
9 to consider any of this legal and economic context.

10 Or, to put it another way, the OFT fails to consider
11 whether the anticompetitive potential effects to which
12 it points are simply features of the UK tobacco market
13 as it operates in any event, or necessarily the product
14 of the RMS agreements.

15 Turning to the RMS's and their introduction, Mr Good
16 explains in his statement at paragraph 14 that the
17 fundamental objective in introducing the RMS's was to
18 incentivise retailers to pass on the full depths(?) of
19 the discounts that were being provided by Imperial to
20 make its products cheaper on the shelves relative to
21 Gallaher.

22 As I explained, the essential problem was that
23 Imperial's lower, as it perceived it, wholesale prices
24 and RRP's were not being passed through.

25 Again, I would like to just take you to the

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1 reference to -- I've already shown you the reference,
 2 I think, to Mr Ridyard.
 3 What Imperial sought to do was to offer incentive
 4 payments to the retailers which were contingent upon
 5 them setting shelf prices for Imperial's products in
 6 accordance with differentials specified in schedules
 7 attached to the trading agreements. As I've said, these
 8 generally reflected the difference in published RRP's.
 9 Professor Froeb has explained that this aspect of
 10 the RMSs, the fact that they encouraged the retailers to
 11 pass on the benefit of wholesale price discounts to
 12 consumers, rendered them pro-competitive.
 13 If we could just look in volume 3 at his first
 14 report, at tab 30, at the top of page 4 of his report,
 15 the first bullet point.
 16 He explains:
 17 "In particular, RMSs can provide a retailer an
 18 incentive to pass wholesale price discounts on to
 19 consumers. With a higher pass-through rate to
 20 consumers, the manufacturer faces an upstream demand
 21 that is more sensitive to price, or more 'price elastic'
 22 in the jargon of economics. The increased sensitivity
 23 to price can result in lower net wholesale prices (as
 24 well as lower retail prices) which, in turn, can cause
 25 rival manufacturers to reduce price. In this way, RMSs

1 can have pro-competitive effects and benefit consumers."
 2 If you would turn on to paragraphs 27 to 28, he
 3 explains that:
 4 "Normally, a retailer would not want to pass the
 5 entirety of a change in the manufacturer 's price on to
 6 consumers. Some of the price change would be absorbed
 7 by the retailer. At first sight, this outcome might
 8 seem to be competitively neutral in that a
 9 manufacturer's price reductions will not be fully passed
 10 on to consumers, but equally that a manufacturer's price
 11 increases will not be fully passed on to consumers.
 12 However, the key point to appreciate is how a low level
 13 of pass-through affects manufacturers' incentives to
 14 raise or lower prices. From the manufacturer's
 15 perspective, a low level of pass-through provides
 16 incentives to raise prices, since the price increase
 17 will not be fully passed on to consumers, and thus the
 18 loss of sales to consumers will not be as large.
 19 Similarly, if a manufacturer were to lower prices, the
 20 retailer would not generally lower them by as much at
 21 the retail level. This reduces a manufacturer 's
 22 incentive to lower prices since it does not produce a
 23 large increase in sales, and conversely creates
 24 incentives to reduce prices less since it does not
 25 produce such a large reduction in sales.

1 "With an RMS, retailers have incentive to pass more
 2 of a wholesale price decrease on to consumers than
 3 without an RMS. This can lead to a larger decrease in
 4 retail prices, and thus a larger gain in sales. Because
 5 a manufacturer 's price decrease leads to a greater
 6 increase in sales with an RMS than without, RMSs provide
 7 greater incentive for manufacturers to lower prices in
 8 the first place. When one manufacturer reduces
 9 wholesale prices, this typically results in a reaction
 10 from rival manufacturers, to further reduce wholesale
 11 prices. Manufacturers ' incentives to increase prices
 12 are reduced by the RMSs for the same reasons.
 13 Accordingly, an RMS can lead to lower wholesale prices
 14 and lower retail prices."
 15 Now, that, a similar point is made by Mr Ridyard, if
 16 you turn back in the bundle to page 92, and we, although
 17 this is a section of the report under exemption
 18 arguments, the points being made apply equally to the
 19 first question you have to consider, the alleged
 20 anticompetitive by object.
 21 So at paragraph 230, he explains that:
 22 "There is a clear pro-competitive, price reducing
 23 and output expanding rationale for the RMSs. A
 24 manufacturer's interest, once it has sold its goods to
 25 retailers, is for the retailer to sell them as

1 efficiently as possible to the final consumer. Any
 2 margin the retailer adds on to the retail price, over
 3 and above what is necessary for the efficient
 4 distribution of the product, operates to the detriment
 5 of the manufacturer, whose goods will thereby be made
 6 less competitive against the goods of competing
 7 manufacturers. Similarly, if the retailer sells
 8 competing brands side by side, each competing upstream
 9 supplier has a legitimate commercial interest in taking
 10 steps to encourage the retailer to promote its brand at
 11 the point of sale at the expense of rival brands.
 12 "However, in the absence of specific incentives
 13 provided by manufacturers, retailers have no reason to
 14 take into account the way in which their conduct affects
 15 the commercial interests of suppliers. For example, if
 16 left to their own devices, retailers will tend to raise
 17 their margins (and hence retail prices) above the levels
 18 that are optimal for manufacturers. This is known as
 19 the double mark-up problem and is caused by the fact
 20 that retailers have no reason to take into account the
 21 impact of their decisions on the profits of the
 22 manufacturer. This retailer self-interest is also
 23 detrimental to consumers because it leads to higher
 24 prices and lower volumes sold to them. Conversely,
 25 aligning the incentives of the manufacturer and the

1 retailer would lead to lower prices and higher volumes
 2 being sold, to the benefit of consumers."
 3 He refers to Professor Froeb and says:
 4 "This is an important part of the context within
 5 which the RMSs should be understood. ITL's conduct
 6 across its trading arrangements with retailers is based
 7 on the pro-competitive motivation of seeking to make its
 8 products as competitively priced as possible against its
 9 immediate rivals. ITL had an interest to pay incentives
 10 to retailers (in the form of bonuses linked to the RMSs)
 11 to ensure that its brands were competitively priced
 12 against their immediate rivals because success in
 13 persuading retailers to act in this way would increase
 14 ITL's sales.
 15 "This is the basic pro-competitive, output-expanding
 16 motivation that provides the clearest and most intuitive
 17 explanation for why ITL sought to include relative price
 18 schedules in its dealings with retailers. It is an
 19 explanation that falls clearly within the group of
 20 vertical restraints that manufacturers might seek to
 21 impose on retailers in order to make retail competition
 22 more intense than it would otherwise be."
 23 In a similar vein in the next tab at paragraphs 3 to
 24 5, where he explains at 3:
 25 "This divergence between manufacturer and retailer

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1 incentives provides a straightforward explanation as to
 2 why ITL might want to use an instrument such as an RMS
 3 to encourage the retailer to favour its brands over
 4 rival brands. Retailers would otherwise be more or less
 5 indifferent about consumers switching their purchases
 6 between ITL and Gallaher brands as long as the consumer
 7 continued to buy from that retailer, whereas for ITL
 8 such brand switching results in lost sales and profits.
 9 Hence, it is in principle clear to see how an incentive
 10 such as an RMS could be designed to change the
 11 retailer's incentives, rewarding the retailer for doing
 12 something (i.e, favouring ITL's brand) that matters to
 13 ITL but that would otherwise be of at best secondary
 14 importance to the retailer.
 15 "This observation plays an important role in
 16 understanding why a manufacturer such as ITL might
 17 legitimately seek to introduce incentive payments to
 18 retailers to encourage them to set retail prices such as
 19 to favour its brand over rival brands. The adoption of
 20 such contracts also creates incentives for manufacturer
 21 A to reduce its wholesale price since the incentive
 22 payments increase the likelihood that the retail price
 23 of A1 will fall relative to B1's retail price following
 24 such a wholesale price cut.
 25 "5. This, in essence, is what I understand to be

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1 the benign commercial rationale for ITL's introduction
 2 of RMSs. ITL believed such incentives could encourage
 3 retailers to sell higher volumes of its brands than
 4 would otherwise be the case if it made such incentive
 5 payments. Because this motivation involves ITL seeking
 6 to sell higher levels of its output than would otherwise
 7 be the case, and because to do so it has to make
 8 incentive payments to its customers (i.e effectively to
 9 reduce the net price at which tobacco products are sold)
 10 I believe it is clear that this is a straightforward
 11 pro-competitive motivation. At a minimum, this
 12 pro-competitive motivation, which follows directly from
 13 GS's own identification of an incentive conflict problem
 14 that exists between manufacturers and retailers, must be
 15 included as part of the evaluation of the intended and
 16 actual impact of such arrangements on competition.
 17 I therefore disagree with" Professor Shaffer's
 18 conclusion, which he sets out.
 19 I invite you to look at paragraph 6 as well. Now,
 20 at this stage, I would like to emphasise five points
 21 about the differential provisions.
 22 The first point --
 23 **DR SCOTT:** Can we go back to the double margin point?
 24 **MR HOWARD:** Yes.
 25 **DR SCOTT:** What you have told us so far is that there is

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1 a dramatic difference between the very low margins, and
 2 5 per cent has been mentioned, that retailers are making
 3 on tobacco products, and the 25 to 45 per cent that they
 4 are making on other products.
 5 Now, you can explain that in terms of taking out the
 6 high percentage of tax and looking at the remaining
 7 amounts, but in terms of a simple approach to double
 8 margin, it seems to be a much greater problem in almost
 9 anything else that these retailers are selling than it
 10 is in tobacco where the margins are so tight for them.
 11 You have mentioned the footfall argument as one of
 12 the reasons why a retailer might be inclined to take
 13 a low margin.
 14 **MR HOWARD:** Is your question why are there low margins on --
 15 **DR SCOTT:** No. There are low margins, I think we are all
 16 agreeing that there are low margins.
 17 **MR HOWARD:** Yes.
 18 **DR SCOTT:** What we are being told here is that:
 19 "Any margin that the retailer adds on to the retail
 20 price [I am on paragraph 230 that you read out to us
 21 earlier on from tab 25] operates to the detriment of the
 22 manufacturer whose goods will thereby remain less
 23 competitive against the goods of competing
 24 manufacturers."
 25 What we are looking at here is, as you have

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1 explained to us, a situation where both manufacturers
2 are expecting retailers to trade at what are low margins
3 compared to the other products that they are -- insofar
4 as the double marginalisation problem occurs, it appears
5 to be a much lower problem here than in relation to
6 others.

7 **MR HOWARD:** It's not being said here that the double
8 marginalisation problem is peculiar to the sale of
9 tobacco. Paragraph 230 is dealing with ... yes. 234
10 explains, I think it may answer your point in that it
11 deals with the position of low margins. We might have
12 already looked at that:

13 "In a setting where retailers' margins make up a
14 very small element of the typical retail price (under
15 10%) both economic theory and observed market conduct
16 predicts that retailers have muted incentives to pass
17 through manufacturer wholesale price cuts or
18 unconditional bonus payments in the form of lower prices
19 as discussed in Section 2 of this report, this arises
20 from the fact that even a large cut in retailer
21 remuneration will affect retail prices (and hence
22 consumer demand) only marginally. Hence, the ability:

23 And so on.

24 The point is, where there is a very low margin,
25 there is less ability and less incentive of the retailer

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1 to cut its margin in order to reduce the price, and so
2 where the manufacturer is reducing the wholesale price
3 in order to try to encourage the retailer, there is less
4 incentive for the retailer to pass that on because it's
5 a situation where essentially he is interested in trying
6 to increase his margin.

7 **DR SCOTT:** Yes.

8 **MR HOWARD:** That's --

9 **DR SCOTT:** We will see, when we come to the retailers, that
10 there's quite a lot of evidence about the worry about
11 the margins that they were making and their desire to --
12 bearing in mind their worries about other retailers --
13 to keep your margins as high as they could, small though
14 they were.

15 **MR HOWARD:** Yes. So the double marginalisation problem is,
16 I would respectfully suggest, in fact more acute where
17 the retailers' margins are themselves very low,
18 particularly as a percentage of the overall selling
19 price of the product.

20 You can't look at one factor on its own. You have
21 a situation where the retailers actually are not
22 naturally interested in promoting tobacco. They are
23 interested in competing against other retailers, but
24 they are not per se, they don't see this as a product
25 which they want, where they want to cut the price in

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1 order to get people in. It's not "let's cut the price
2 of baked beans and people will come and buy a lot of
3 other things", so they don't want to be seen to be doing
4 that. So that's the first thing.

5 Then they are in fact anyway earning very little and
6 see their margins as very tight, and from their
7 perception, reducing their margin, because the margin is
8 only a small component of the price, does not have
9 a major effect on the price in any event. That's part
10 of the difficulty.

11 So it is, I would suggest, part of the background,
12 part of the difficulty that was being faced, and
13 explains why Imperial was seeking to provide incentives
14 to the retailers notwithstanding these difficulties,
15 whereby they would in effect pass through their lower
16 prices.

17 **THE CHAIRMAN:** Perhaps we will come back to your five points
18 after a short break, Mr Howard.

19 **MR HOWARD:** Yes.

20 **THE CHAIRMAN:** We will resume in about 10 minutes.

21 (11.30 am)

22 (A short break)

23 (11.45 am)

24 **MR HOWARD:** If I can just pick up two points that arose out
25 of discussions this morning. Firstly, what is known

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1 about the wholesale prices is the RRP's but in fact also
2 each of the manufacturers does publish wholesale price
3 lists which are sent around to thousands of retailers,
4 including small corner shops and so on, so there is in
5 fact knowledge of what that wholesale price is. Of
6 that, of course there are volume discounts which are
7 unlikely to be particularly different, but then there
8 are individual bespoke discounts, which is really what
9 all of this is about, is trying to compete with the
10 individual bespoke discounts that you perceive are being
11 offered by the competitor.

12 Now, the other point, before making some specific
13 points on all of this, is to take you back to Mr Ridyard
14 in volume 3, tab 25, where he also explains this point
15 about the lack of incentive for retailers.

16 It's page 33, the bottom bullet point under
17 paragraph 59:

18 "Incentives to the retailer to pass on wholesale
19 price reductions in the form of specific conditions,
20 such as the offer of wholesale price reductions that are
21 contingent on a given corresponding reduction in the
22 retail price. Such incentives are particularly likely
23 to be present where the retailer's gross margin is small
24 relative to the overall consumer price. For example, if
25 the retailer's gross margin on a £3.98 product is just

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1 10p, a 3p wholesale price reduction increases the
 2 retailer's gross margin by roughly 30% if retained by
 3 the retailer, but would reduce retail price by less than
 4 1% if passed on to the consumer. The retailer would
 5 need to believe that such a small retail price cut would
 6 have a very large impact on boosting sales in order to
 7 justify a decision to pass on this wholesale price cut.
 8 In the absence of specific incentives, the retailer is
 9 thus very unlikely to pass on the wholesale price cut --
 10 not least because of the added negative effect of
 11 possibly cannibalising the sales of products on which it
 12 makes a higher margin."

13 So that graphically, I would suggest, explains again
 14 why the retailers here don't have an incentive to pass
 15 on to the consumers the effect of a discount in the
 16 wholesale price.

17 Now, just turning to the five points that I said to
 18 you that I wanted to draw out, the first question is:
 19 one needs to be clear about the types of payments that
 20 Imperial was making, because what Imperial was actually
 21 seeking to do, at the same time as introducing the RMSs
 22 into the trading agreements, it was seeking to
 23 incentivise the retailers in a variety of ways in order
 24 to achieve better distribution of Imperial's products
 25 and to improve the visibility of Imperial's products in

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1 the stores.

2 So what it was offering were what were called trade
 3 development payments to the retailers, and they were
 4 offered in order, firstly, to encourage the retailers to
 5 set prices in accordance with the desired differentials,
 6 and secondly to support point of sale advertising and
 7 marketing material and stocking the complete range of
 8 products as well as achieving specified levels of
 9 distribution throughout the networks so that the RMSs
 10 were only one component of the trade development
 11 payments. That is significant because there is no
 12 suggestion that any other aspects of the strategy or
 13 agreements were anything other than pro-competitive.

14 Now, the RMS payments themselves were extremely
 15 small. Mr Ridyard has carried out an analysis in his
 16 second report, and that shows that for most of the
 17 retailers to whom the decision is addressed, the bonus
 18 is paid by Imperial for adherence to the RMS schedules,
 19 contributed between [redacted] of their remuneration.
 20 You can see that at {C3 tab 26, pages 124} onwards, and
 21 I don't need to read it out.

22 **THE CHAIRMAN:** There is are quite a lot of confidential
 23 squaring there, so perhaps if you just direct us to what
 24 to read.

25 **MR HOWARD:** The conclusion on all of this is at

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1 paragraph 62. (Pause).

2 **DR SCOTT:** The same point that we made earlier on about the
 3 margins applies, that if you strip out the taxation
 4 component and you think about the X tax margins, then
 5 the figures become much larger.

6 **MR HOWARD:** I am not sure that's right.

7 **DR SCOTT:** The percentages. This is, if you look at the
 8 heading on page 124 "Bonus payments as a percentage of
 9 retail sellers including taxes", bearing in mind what
 10 you were saying to us just now about the percentage
 11 changes when you take the taxation out.

12 **MR HOWARD:** But paragraph 62, I think, is then explaining
 13 the position excluding taxes. If you look, the figures
 14 including taxes are literally tiny, the figures
 15 excluding taxes are very small, and it's the very small
 16 that I am concentrating on, not the literally tiny ones.

17 If you focus on the figures on pages 124 and 126,
 18 one really would say this is virtually nothing. So it's
 19 the figure excluding taxes in paragraph 62 which is the
 20 more important one, which is still, as Mr Ridyard
 21 describes it, a very modest contribution.

22 The next point I want to raise is the question of
 23 whether there was any restriction imposed on the
 24 retailers by the trading agreements. We suggest there
 25 is -- I am sorry.

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1 **DR SCOTT:** Forgive me. You started by saying you were going
 2 to go through the types of payment.

3 **MR HOWARD:** Sorry. There is that -- what I was seeking to
 4 explain to you was you have the trade differential
 5 payments which have a number of elements to it. The RMS
 6 payment is only one element.

7 **DR SCOTT:** Yes, but as I understand it, there are other
 8 forms of bonusing.

9 **MR HOWARD:** There are other forms of bonuses, there are the
 10 off-invoice payments for pricing below RRP, there are
 11 also what you call these bonuses, there are volume
 12 discounts, I am not sure one would really call that
 13 a bonus, it's just a standard thing. There were then
 14 also occasionally -- or more than occasionally, quite
 15 frequently, there were particular promotional tactical
 16 bonuses.

17 **THE CHAIRMAN:** What you are saying is that the point -- the
 18 payments, such as they were, for abiding by
 19 differentials was bound up with what you call the trade
 20 development payments rather than bound up with the
 21 off-invoice payments for pricing below RRP?

22 **MR HOWARD:** Absolutely, yes. The point is off-invoice
 23 payments for pricing below RRP, again one doesn't
 24 necessarily know the precise strategy that the different
 25 retailers will operate in their discussions with the

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1 manufacturers, but what one does know is that if, for
 2 instance, Tesco's policy is to price below RRP and they
 3 are looking for support to do that, that Sainsbury's are
 4 going to be seeking to do the same because they are
 5 benchmarking against Tesco and so on, and equally one
 6 would anticipate that they are going to be having the
 7 same dialogue but with Gallaher and Imperial. In other
 8 words, there is no reason to infer that they are
 9 adopting a differential strategy where they say "Well,
 10 we want to price Gallaher below RRP but not Imperial",
 11 because they have no reason, there is no sensible reason
 12 why they would be doing that. Of course, the different
 13 manufacturer may be paying them a greater incentive to
 14 have a greater reduction. But that again comes back to
 15 the competition and what Imperial were seeking to
 16 achieve.

17 Moving on from the types of payment, the question
 18 is: what actually was the nature of the arrangement?
 19 Now, we suggest that it is clear that Imperial did not
 20 impose any restriction upon the retailers in the sense
 21 of imposing an actual obligation to comply with the
 22 differentials. Imperial simply provided them with
 23 an incentive: if you set your prices for Imperial's
 24 products in accordance with our desired differentials,
 25 then we are prepared to pay you a bonus. That is

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1 important when you come to consider the theory of harm
 2 and the way in which that is supposed to operate,
 3 because there are two important levels to it. The first
 4 is that there is an obligation on the retailers to apply
 5 the differentials, and the second is that it's
 6 an obligation to apply those differentials at all times,
 7 and irrespective of price promotions or price cuts by
 8 Gallaher or price increases by Imperial.

9 The nature of the incentive payments is, again,
 10 helpfully explained in Mr Ridyard's report at {C3,
 11 tab 25, paragraph 65}:

12 "RMSs are incentive payments offered to retailers
 13 and whose payment is contingent on the retailer meeting
 14 specific pricing schedule criteria. They do not prevent
 15 retailers from taking independent retail pricing
 16 decisions — they simply provide an incentive to the
 17 retailer to pursue conduct that is specified by the
 18 manufacturer. The impact of such incentives on retailer
 19 behaviour must depend on a trade-off facing the
 20 retailer between the commercial benefit of accepting the
 21 incentive payment from that manufacturer, and the other
 22 implications to the retailer of adjusting its pricing
 23 behaviour to meet the preferences of any one supplier."

24 He makes a similar point, if you turn to the next
 25 tab, at page 132, where he explains at 82:

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1 "As I understand it, there is nothing in the trading
 2 agreements that oblige a retailer to adhere to the RMSs
 3 once the trading agreement has been signed. A retailer
 4 may find that, after signing the trading agreements, the
 5 actual losses it would incur if it adhered to the RMSs
 6 exceed the bonuses (based on estimated losses) that the
 7 manufacturer agreed to pay for adherence. Hence, a
 8 retailer may strategically decide not to adhere to the
 9 RMSs in the trading agreements if such a course of
 10 action is more profitable than adherence. This suggests
 11 that retailers' incentives to agree and/or adhere to
 12 RMSs should form a part of any analysis of the effects
 13 of the RMSs when retailers do not adhere due to their
 14 own strategic conduct."

15 **DR SCOTT:** Mr Howard, you referred to the arrangement, and
 16 you rightly imply that we are looking not just at the
 17 trading agreements but at the rest of the documentary
 18 evidence, in which a variety of language occurs, and no
 19 doubt we will return to that, but there seemed to have
 20 been moments when the language employed suggested more
 21 of an obligation than on other occasions when it was
 22 more of an invitation.

23 **MR HOWARD:** Yes, but the question you have to decide about
 24 all of this, the case that is being put is that there is
 25 an agreement. The agreement, they say, is not simply

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1 contained in the trading agreements but it's contained,
 2 evidenced by the correspondence. Okay, I understand
 3 that. You have still to decide: what is the agreement?
 4 The agreement, they say, is one which required the
 5 retailers to act in a certain way. Now, what one then
 6 has to do is to see: was there any such agreement?

7 If you look at the trading agreements themselves,
 8 which prima facie are what govern the relationship
 9 between the parties, we would say it is absolutely clear
 10 that the payments that are being offered are incentive
 11 payments and there is no obligation on the part of the
 12 retailers. You can test that in quite a simple way: ask
 13 yourself, when you have read those agreements, if the
 14 retailer fails to follow this strategy or fails to
 15 follow what's called the requirements, could Imperial
 16 sue for breach of contract? Was Imperial entitled to
 17 say "I've suffered sales loss because you haven't
 18 followed this"? In our submission, it's patently clear
 19 that that isn't the case.

20 **THE CHAIRMAN:** Are you making here, and maybe this will be
 21 a point for Mr Brealey in due course, a point about
 22 whether this was an agreement or a concerted practice
 23 within competition provisions, because obviously one
 24 doesn't need a binding contractual obligation of that
 25 kind.

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1 **MR HOWARD:** The point I am making, and I recognise you don't
 2 have to have a binding obligation, one what is trying
 3 to -- one can only deal with the case that is put
 4 forward by the OFT. The case that's put forward by the
 5 OFT is whether you call it an agreement, whether it's
 6 legally binding or whether you call it a practice, the
 7 effect of this was that the retailers were required to
 8 act in a certain witness statement, and particularly
 9 required if Imperial put up its price, to put up the
 10 price of Gallaher correspondingly; if Imperial put down
 11 the price, to put down the price of Gallaher, and
 12 equally if Gallaher put up the price, you put up
 13 Imperial, and if Gallaher put down the price, you put
 14 down the price.

15 What one has to see is: was there any such
 16 requirement in any of these relationships? You have to
 17 start at the agreements to see, well, did the agreements
 18 do that, and then you have to look and see, well, is
 19 there some other arrangements, understanding between the
 20 parties that this is how it's to operate?

21 What the OFT has done, and we say this is really
 22 where their analysis goes wrong, they try and divorce,
 23 set aside the agreements and say "Ah, well, we can point
 24 to some correspondence with some of the retailers where
 25 we see you talking about, for instance, the price of

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1 Gallaher". We will obviously have to look at that. The
 2 question is: what actually do you deduce from that? The
 3 fact, for instance, that -- which is one of the ways
 4 that it's put -- you see Imperial, to use the word that
 5 the OFT uses, encouraging a retailer to say to Gallaher
 6 they ought to put up their prices. How does this fit
 7 with the theory of harm? I can see one might say, well,
 8 that's not something necessarily you ought to have been
 9 saying, but the question is how does it actually fit
 10 with the case that the OFT has put, and how is that
 11 an object infringement?

12 Amongst this morass of detail, I am afraid that's
 13 always what you have to come back to. What is being
 14 said here is that there is either an agreement or
 15 a concerted practice which by its object is
 16 anticompetitive.

17 You have to be very clear, if you are bringing
 18 an object case, we would suggest, as to what is the
 19 object of the agreement or of the practice, you have to
 20 be able to define that, and then you have to be able to
 21 say why that has an anticompetitive effect.

22 The OFT seeks to face up to that by what's been
 23 described I think in some of the skeletons as a rather
 24 stylised theory of harm, and that is that the principal
 25 theory of harm is that there is in fact a requirement

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1 for this lock-step mechanism of all the prices moving up
 2 and down.

3 We say that is simply wrong, there was never any
 4 such requirement, and simply to say: I can point to
 5 a couple of letters where you said: wouldn't it be
 6 good -- that's what I think they said in one case -- if
 7 Gallaher followed. What is that showing in terms of the
 8 case that they are putting? We say it's not showing
 9 anything at all. It may be showing, they may say, well,
 10 and if they were conducting a different enquiry, that
 11 these were some sort of inappropriate communications
 12 although they have given up that case, you have to
 13 remember, and say this is having an adverse effect on
 14 the market, but that is not actually the case we are
 15 facing.

16 **THE CHAIRMAN:** The point you make, that, well, could they
 17 have sued them for failing to abide by the
 18 differentials, if one looked at it the other way around
 19 and said: well, supposing one of the retailers had
 20 complied with the differentials, and then Imperial
 21 refused to give them that discount, then there would
 22 have been a sense of sort of feeling of, well, you have
 23 not done what you promised.

24 **MR HOWARD:** No, no, I think you are misunderstanding my
 25 point.

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1 **THE CHAIRMAN:** It's that kind of contract, it's a sort of --

2 **MR HOWARD:** It's an "if" contract. I am not saying it isn't
 3 a contract.

4 **THE CHAIRMAN:** I suppose your point is if it's only
 5 an incentive rather than obligation on the part of the
 6 retailer, then the small size of the actual bonuses is
 7 more of a relevant factor than it would be if it were
 8 a real contractual obligation, in which case one
 9 wouldn't really be interested in what the size of the
 10 incentive was because they would have an obligation. So
 11 I can see the two things go together.

12 **MR HOWARD:** Precisely. You have to approach this at
 13 a number of levels. The first question you have to
 14 decide is: what is the nature of the relationship here
 15 vis-a-vis these bonuses? Was the situation that the
 16 retailers were absolutely obliged to do this? Or, was
 17 it an incentive, if you do this. It doesn't mean there
 18 isn't a contract there, but it's a different type of
 19 contract.

20 Then the next level down is, whichever answer you
 21 give to that, and we say there is only one, but it
 22 doesn't really matter, you have then got to ask
 23 yourself: what is the harm that's being said to arise
 24 from either type of arrangement, and the OFT's case is
 25 that the harm is that the way this is supposed to

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1 operate and was operating was that if you change your
2 prices then the retailer has to change the price of
3 Gallaher's prices. Or if Gallaher reduces its price,
4 then the retailer has to reduce your price. So in other
5 words they say: because that is what is required of the
6 retailer, that disincentivises Gallaher from cutting its
7 prices and incentivises Imperial to raise its prices.

8 We say none of that is actually correct, just as
9 a matter of fact, before you get to the question as to
10 whether or not in economic theory it works. We don't
11 accept even that is so. But what we say is that where
12 there are price movements, so if Imperial cuts its
13 price, it has no interest whatsoever in the retailer
14 moving Gallaher's price down, it's cutting its price
15 because it wants to get an advantage.

16 Equally, if it puts up its price, Imperial may
17 rather hope -- and that's all some of that
18 correspondence shows -- that Gallaher will follow suit,
19 but there is no obligation on the retailer, absent
20 Gallaher following suit, no obligation in any event, but
21 there is nothing that Imperial has as an expectation or
22 obligation on the retailer for the retailer to increase
23 the price of Gallaher --

24 **THE CHAIRMAN:** The incentive to do whatever it is that they
25 are doing, or the conduct, if I can put it this way, the

1 conduct which Imperial is trying to bring about is the
2 same, whether it's doing it by way of providing
3 an incentive or by way of imposing a restriction. I am
4 not quite sure where this point about: was it
5 a restriction or was it just an "if" contract with
6 an incentive, how that fits in with the question of
7 what --

8 **MR HOWARD:** It fits in, in a number of respects, but
9 particularly it fits in when you come to consider how
10 this was intended to operate when the prices changed,
11 because the question is: well, did the parties
12 anticipate, what did they anticipate was going to happen
13 to these bonuses where, for instance, Gallaher reduced
14 its price? Well, the opportunity to respond clauses
15 actually show that the parties anticipated that the
16 bonuses would have to be renegotiated, in other words
17 all that happens is if Gallaher has a price reduction,
18 then Imperial, faced with that, may try to meet it. In
19 other words, normal competition. We say there is
20 nothing about the agreement which is in any way
21 disrupting the normal competitive process. Equally,
22 what you see when Imperial puts up its prices, Imperial
23 doesn't have any expectation that the retailer is going
24 to, as a result of Imperial putting up the price, put up
25 Gallaher's price, and that's why actually it announces

1 a price increase but then says "Oh, well, keep the price
2 down and I'll pay you a bonus, carry on paying you
3 a bonus to do that", because they have no certainty that
4 Gallaher are putting up the price, so they watch like
5 a hawk to see whether Gallaher does, and if they do then
6 the price increase will be implemented and that's
7 completely inconsistent with some idea that what is
8 happening here is price co-ordination.

9 The fact that you hope -- because you are affected
10 by a common factor causing you to put up prices -- that
11 your rival is affected to the same extent and will also
12 follow with a price increase doesn't mean that you are
13 imposing any obligation or have any expectation, that's
14 the important thing, of the retailer just putting up the
15 rival's price because you put up your price.

16 Now, the next point on the differentials I want to
17 address is the question of: were they fixed, by which
18 one means they are specifying a fixed difference between
19 Imperial's price and Gallaher's, or were they providing
20 for maximum prices of Imperial's product by providing
21 a relativity to the Imperial product.

22 We say it was never Imperial's intention to prevent
23 or discourage retailers from pricing below the levels
24 specified in the trading agreements. That point is
25 confirmed at various places in our witness evidence.

1 I'll just give you the references. Mr Good's first
2 statement at {paragraph 19, core 3, tab 36}; Mr Batty,
3 also {core 3, tab 33, paragraph 4.48}; and Mr Matthews,
4 paragraph 52 at tab 42.

5 That point is also confirmed by the retailers'
6 witnesses, Mr Eastwood of Morrisons at paragraph 16,
7 core 8, tab 94; and in the witness statement of
8 Fiona Bayley, who as we know the OFT are calling, and
9 that is in {core 6, tab 69 at paragraph 41}.

10 The fact that Imperial would only ever seek to
11 provide for relative maximum prices makes commercial
12 sense because Imperial would have no reason to
13 disincentivise retailers from pricing its products as
14 lower levels. On the contrary, Imperial was trying --
15 and there are so many documents to evidence this -- to
16 push for lower prices in order to gain market share. So
17 it would always be happy if the retailers lowered the
18 price. The sole objective of the pricing differentials
19 was to incentivise the retailers to pass through the
20 full benefit of Imperial's discounts so as to make its
21 prices -- it's retail prices -- cheaper. So it's
22 unsurprising that the trading agreements did not impose
23 parity or fixed differential requires.

24 In most cases, the trading agreements are pretty
25 unequivocal about this and they provide in terms that

1 Imperial's particular brand should be no more expensive
 2 than or at least [X]p less than the Gallaher brand. It
 3 is true that in a couple of cases, namely Sainsbury and
 4 in one or two of the differentials in the case of
 5 Morrisons and TM Retail, the differentials were
 6 expressed in terms that Imperial's brands should be
 7 +[X]p or -[X]p or parity or level with.
 8 When you see the complete context, we suggest it is
 9 clear that it was not intended that the retailer was
 10 obliged to set prices at those levels, and that this was
 11 simply shorthand for providing that the prices should be
 12 no more than X more expensive than or X less expensive
 13 than, and so on.
 14 **DR SCOTT:** Mr Howard, you talked earlier on about the extent
 15 to which Imperial and Gallaher knew about the way in
 16 which the market was structured, and at the moment you
 17 are talking about a situation in which we are looking at
 18 unilateral behaviour.
 19 **MR HOWARD:** Yes.
 20 **DR SCOTT:** But the decision talks about bilateral behaviour,
 21 and that does somewhat change the position, so that if
 22 you have got arrangements in which both Imperial and
 23 Gallaher have in relation to the same pairs of products.
 24 Again I want to be careful here not to use the words
 25 "similar" or "parallel".

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1 **MR HOWARD:** With respect, that is incredibly important, and
 2 to see the shift in the OFT's case on this from the
 3 decision to the defence, the decision contains the
 4 assertion that there were parallel and symmetrical
 5 arrangements between Imperial and Gallaher. When the
 6 evidence points out that's wrong, there were not, they
 7 end up saying: oh, well, there were similar
 8 arrangements, and that's their case.
 9 Now, "similar" is quite different to something where
 10 you say there is parallel and symmetrical, because it
 11 raises the question as to -- if they are parallel and
 12 symmetrical, you can understand it being said, ah, well,
 13 the retailer could follow both because they are set in
 14 such a way that actually they create a lock-step
 15 mechanism. Once they are not parallel and symmetrical,
 16 then you actually have got inconsistent requirements.
 17 So one has to consider: how does that operate? Indeed,
 18 that goes a long way to explaining why, to some extent,
 19 the OFT is now retreating from this and saying, oh,
 20 well, it's not a key part of our case to find that they
 21 were parallel and symmetrical. Essentially what they
 22 say is that the arrangements that Imperial had were bad
 23 arrangements by their object, and because they were bad
 24 it's even worse that they were parallel or symmetrical
 25 or now similar arrangements, but it is simply saying two

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1 lots of bad agreements are bad. But one has to come
 2 back to ask, and that's the case we are meeting, whether
 3 or not the arrangement that Imperial entered into was
 4 bad, was unlawful by its object.
 5 **DR SCOTT:** Would we be correct in taking into account the
 6 context of whatever understanding we later find out that
 7 there was into account in understanding the object of
 8 any agreement or arrangement that we find may have been
 9 in place?
 10 **MR HOWARD:** I am not sure I follow. In my submission,
 11 because this is an object case, you have to look at the
 12 agreement or practice which is alleged. If the
 13 agreement which is alleged is that between Imperial and
 14 the retailer, you have to ask yourself what that was if
 15 what's being alleged is, well, there is a network of
 16 arrangements giving rise to the practice, which includes
 17 your knowledge of the arrangements that Gallaher had, so
 18 you are looking at it as a body, then yes, you have to
 19 ask yourself what knowledge was there, and if all that
 20 you are saying -- and this is all that -- I'll come back
 21 to this later on, but if all that's being said is, well,
 22 you had some knowledge in general terms of Gallaher's
 23 trading strategy, well, you have that knowledge in
 24 general terms from the RRP's, because the RRP's tell you
 25 which brands -- you can see from that which brands they

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1 are -- well, what price level they are aiming for their
 2 brands, and of course they know your RRP's, so you know
 3 the extent to which they are seeking to set their prices
 4 for that particular brand above or below yours.
 5 The question of how these differentials were, what
 6 was the agreement as to how they were to operate,
 7 because what the OFT says is, well, I mean, they agree
 8 that a large number of the agreements provide for
 9 relative maxima, but they say, no, that's not actually
 10 how it was intended to operate or how they were
 11 operated, and they point to correspondence which they
 12 say talks about specific price points and therefore that
 13 must show that you intended something different.
 14 Now, this is one area where the adherence analysis
 15 is relevant, to see the extent to which the retailers
 16 were adhering on the basis of fixed differentials and
 17 the extent to which they were adhering on the basis of
 18 relative maxima.
 19 The analysis you will find at {C3 tab 26}. This is
 20 Mr Ridyard's second report. There has been a debate
 21 between Mr Ridyard and Mr Walker as to the right way to
 22 go about it, but that's all fallen by the wayside, you
 23 will be pleased to know you don't have to worry about
 24 that.
 25 What you have on table 4, actually you can look at

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1 table 5, which compares adherence to the exact RMSs, in
 2 other words on the basis of their fixed and adherence to
 3 maxima RMSs, and you can see that if you look at the
 4 first column, on the whole, if you looking at adherence
 5 to exact RMSs, the percentage levels are, on the whole,
 6 fairly low. Most of them are somewhat below
 7 50 per cent. There are only two cases where it's above.
 8 Whereas if you look at adherence to, on the basis of
 9 maxima, one sees that the levels are generally much
 10 higher, and in some cases in the 75 to 80 per cent
 11 level, certainly a number of cases above 70 per cent.

12 Table 6, while one has it, is an interesting
 13 comparison of the retailers' adherence to RMSs to
 14 correspondence with Tesco.

15 In the experts' joint statement, Mr Walker agrees
 16 with the adherence results in this report. So it's not
 17 controversial. But the point is, if one is saying, if
 18 what the OFT is saying is: well, actually the parties
 19 were intending to agree something different to what is
 20 contained in the agreements, what one would expect to
 21 see is that the adherence to exact RMSs was high, and
 22 one wouldn't expect to see this differential between
 23 maxima adherence and exact levels.

24 The next point is a question which the OFT has
 25 thrown out, which is: why did Imperial seek to impose

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1 relative maximum prices rather than absolute maximum
 2 prices. In other words, why did Imperial say "We want
 3 to be at least 3p less for Embassy than B&H"? Why
 4 didn't they say "We want you to price Embassy at no more
 5 than £3.90", or whatever the price might have been? The
 6 OFT suggests in its skeleton at paragraph 54, its
 7 written opening, that the question of why the
 8 manufacturers needed to create formal linkages between
 9 the retail prices of their competing rival brands
 10 remains unanswered. Well, that's simply wrong.
 11 Imperial has consistently explained that whilst as
 12 a matter of principle or theory it could have provided
 13 for absolute maximum prices rather than relative maxima,
 14 in practice that would not have been possible or at the
 15 very least would have been extremely difficult.

16 The reason for that is because of the very diverse
 17 pricing strategies that the retailers had: for example,
 18 some of them operated a number of pricing tiers across
 19 different outlets, and others gave discretion to
 20 individual store managers to vary prices according to
 21 local competitive conditions.

22 So it's unlikely that the retailers would have
 23 agreed to a scheme based on absolute maxima, as they
 24 would have regarded that as removing too much of their
 25 discretion. Furthermore, it would have been impractical

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1 to administer absolute maximum prices.

2 Perhaps you could turn to Mr Good's statement on
 3 this at tab 37, where he in terms addresses this point.

4 He says at paragraph 16:

5 "In light of the above, I consider that providing
 6 funding to retailers if they priced below stipulated
 7 absolute maximum prices would have been extremely
 8 onerous as it was easier --"

9 **THE CHAIRMAN:** Is that 50 lists and 90 SKUs, is that
 10 assuming that there would be a maximum price set for
 11 every cigarette?

12 **MR HOWARD:** Yes.

13 **THE CHAIRMAN:** But the pricing schedules of relative maxima
 14 don't apply, do they, to every one of Imperial's range
 15 of products?

16 **MR HOWARD:** No, but it applies to -- I think we are at
 17 cross-purposes. 50 lists of absolute maximum prices,
 18 one for each tier, so there are two different points.
 19 You have the different tiers of the retailers, and then
 20 the number of different products. Now, you are right
 21 that Imperial didn't seek to promote every single
 22 product because there are some it's not interested in
 23 promoting, so it's not interested in packets of 10, for
 24 instance, and there are, I think, other brands which it
 25 no longer wishes essentially to promote, I suppose the

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1 theory is they are effectively dying brands, and so we
 2 don't really care. So it may not be as many as 90, but
 3 the force of the point is not diminished.

4 The critical point is that, if you had absolute
 5 maximum prices, you would need to set an absolute
 6 maximum price according to the tier in the different
 7 shops. So there may be one type of shop where you are
 8 saying £3.95 is the absolute maximum, and there is going
 9 to be another where it's 3.92 and so on, depending upon
 10 the retailer's strategy, and it becomes very, very
 11 complicated. The beauty of the RMS schedules is of
 12 course that you can apply it across the board. You say:
 13 we want to be at least 3p below Benson & Hedges.
 14 Whatever your strategy across your tiers, that's how we
 15 want to be priced and that's what we are paying you for.
 16 Whereas if you tried to set it as an absolute maxima, it
 17 becomes very, very complicated.

18 One of the points about all of this -- sorry. Let
 19 me just make this point: one mustn't lose sight of also
 20 what this inquiry is about. The inquiry at this stage,
 21 when we are talking about whether or not these
 22 agreements, arrangements, concerted practices, whatever
 23 you want to call it, had an anticompetitive object, you
 24 have to ask yourself: are they themselves creating that
 25 anticompetitive object? The question is not: could you

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1 have done things in a better way? For instance, let's
 2 say one says well, we think from pursuing your strategy
 3 it might be better if you set absolute maxima, and that
 4 might even be more beneficial in creating a more
 5 beneficial competitive environment. That doesn't answer
 6 the question as to whether what you have done is
 7 anticompetitive.

8 **THE CHAIRMAN:** No, it's more relevant to the exemption, the
 9 application of 1013.

10 **MR HOWARD:** Sometimes in the discussion, you will see in the
 11 expert reports it is said -- indeed this bit of the
 12 skeleton argument of the OFT that I was referring to --
 13 well, there are better ways of doing this. They are not
 14 actually at that point addressing exemption. When you
 15 ask yourself whether something has an anticompetitive
 16 effect, it's neither here nor there but you could say
 17 well, I think it might be an improvement if you did
 18 something this way.

19 **THE CHAIRMAN:** But they are addressing what, I suppose they
 20 are addressing what was Imperial's real motivation in
 21 entering into these arrangements.

22 **MR HOWARD:** If that's what they are addressing, we will
 23 obviously have to see what points they put to the
 24 witnesses, we would suggest the evidence is absolutely
 25 overwhelming as to what Imperial's motivation was. It

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1 was trying to feed through lower prices. If one thinks
 2 about it for a moment, if it were being suggested that
 3 the motivation was that by making these agreements, that
 4 Imperial was anticipating the theory that
 5 Professor Shaffer puts forward, one really -- firstly,
 6 you won't see anything in the documents, and you are
 7 really ascribing to Imperial quite a Machiavellian plan,
 8 that we are trying to reduce prices but really what we
 9 are trying to do is increase prices.

10 I am not saying that that's an impossibility where
 11 you are actually saying there was a cartel between the
 12 manufacturers, but what you are pointing to is
 13 an arrangement where what in theory is actually trying
 14 to do on its face is to lower its price, it is rather
 15 counterintuitive to say, well, you must have really
 16 intended to be increasing the prices and how, it remains
 17 unspoken.

18 This evidence is simply explaining, from those who
 19 were involved at the time -- just cast your eye over,
 20 perhaps you have already read it -- why at the time this
 21 wasn't perceived as a way to do things. One can
 22 immediately see that what is being said is that it would
 23 have been very difficult to achieve the strategy of
 24 getting lower prices passed through by doing that with
 25 the retailers.

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1 A similar point is made by Mr Goodall, who is the
 2 current head of sales, that's in the next tab at
 3 {paragraphs 21 to 22, tab 39}.

4 **DR SCOTT:** Thinking back to Mr Good, the effect of what he
 5 is saying is that the primary concern was the
 6 differential that, given the problem that you have
 7 already mentioned of the differentials having been
 8 disadvantageous to Imperial, Imperial now wanted the
 9 differentials to be advantageous to Imperial.

10 **MR HOWARD:** Yes.

11 **DR SCOTT:** Then what mattered was not the absolute level but
 12 the relative level of the prices at the different tiers.

13 **MR HOWARD:** Yes. You have to take it in stages. Stage 1 is
 14 Imperial wants to try and increase its market share.
 15 Its strategy to increase market share is to price cut
 16 below Gallaher, who are the principal competitor. The
 17 next stage is: how can I incentivise the retailer to do
 18 that? What I am interested in is, I am interested in my
 19 prices (a) feeding through the benefit of my lower
 20 wholesale price as I perceive it to be, but also being
 21 thereby below Gallaher, because I believe I am supplying
 22 you with my product at prices which should enable you to
 23 price below Gallaher, and anyway with my discount
 24 overall, because all the discount is really doing is
 25 reducing -- sorry, the bonus, it's only ultimately

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1 reducing the wholesale price. One can get slightly
 2 confused by looking at all the different elements, but
 3 at the end of the day to the retailer what matters to
 4 him is what the bottom line price is that he has to pay,
 5 because that feeds through into his margin.

6 **DR SCOTT:** But given the fact that the elasticity of tobacco
 7 generally was low, and the suggestion is that the
 8 cross-elasticity, price elasticity between brands was
 9 much higher than that, then in terms of building market
 10 share, it is the relativity of the prices rather than
 11 the absolute prices that matter.

12 **MR HOWARD:** Absolutely. The point about if you say you
 13 should have done this by absolute prices, you have to
 14 remember what you would be doing if you set your
 15 absolute price or set an absolute maximum price, you
 16 would always be doing it on the same strategy, it's
 17 simply instead of saying to the retailer: the bonus is
 18 3p, if you are 3p below Benson & Hedges, the bonus is if
 19 you are £3.90 because £3.90 is what I believe will be 3p
 20 below Benson & Hedges. In other words, you are never
 21 going to be doing it in isolation, you are always going
 22 to be doing it in competition. So it's actually
 23 a complete mirage in any event to say absolute maxima.

24 The only difference if you do it by absolute maxima
 25 is firstly it is incredibly complicated and query

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1 whether it can be done, but secondly it seems to be
 2 that, well, it would be all right if your strategy is to
 3 price against Gallaher but you don't tell explicitly the
 4 retailer that's what you are doing. In other words, so
 5 that you are constantly looking at the prices and when
 6 you see Gallaher's at £3.90 you say right, I want
 7 Embassy to be £3.88. That apparently would be okay, or
 8 maximum £3.88, but it's not okay to say "I want it to be
 9 at least 2p in that example less".
 10 It's actually a distinction without a difference, it
 11 just goes to the mechanics. Ultimately you come back to
 12 not whether absolute maxima would have been better than
 13 relative maxima, but to the question whether there is
 14 some anticompetitive object in doing it this way. As
 15 I say, you can't actually -- I've explained, there is no
 16 point to it in any event, because it simply goes as to
 17 how explicit you are in your strategy, but it's always
 18 going to be the same strategy, particularly where what
 19 you are trying to do is to make yourself relatively
 20 cheaper than your competitor.
 21 It's now become common ground -- when I say now, it
 22 was at the time of the decision as well -- that the
 23 retailers were free to set the absolute level of their
 24 retail prices. The OFT itself says that in the decision
 25 at various paragraphs with some references, 6.142,

1 6.220, and 6.250.
 2 So the allegation of resale price maintenance has
 3 disappeared. That was an allegation at paragraph 13 of
 4 the SO.
 5 It is important to recognise that this allegation
 6 has gone, because the decision and the defence and
 7 indeed the skeleton here are replete with references to
 8 Imperial monitoring prices, micromanaging prices, and
 9 instructing the retailers to set prices at specific
 10 price points.
 11 Once the allegation of resale price maintenance has
 12 gone, what one has to ask in relation to all of these
 13 allegations on the evidence is: what actually are they
 14 going to? One can see that they are used sometimes in
 15 a prejudicial way. But the question is: what actually
 16 are they going to?
 17 Now, communications about price between
 18 a manufacturer and a retailer and about the retail price
 19 are themselves perfectly normal. It is also the case
 20 that the retailers here themselves sought the
 21 administrative assistance of Imperial because they
 22 themselves often experienced difficulties in
 23 implementing their own pricing strategies.
 24 Difficulties arise at a number of levels. One, they
 25 have difficulties because they have these different

1 pricing strategies, and they may not have been
 2 necessarily competent at all stages in implementing
 3 them. But also the effect of tax changes, they very
 4 often look to Imperial in relation to its products to
 5 ensure that the appropriate changes were being made.
 6 Now, Mr Batty deals with this at {C3 tab 33, page
 7 355, 6.4}:
 8 "It's also the case ...(Reading to the words)...
 9 Price reductions funded by ITL."
 10 A similar point is made by Mr Cheyne at
 11 paragraphs 35 to 37.
 12 When you come to consider the correspondence, you
 13 will need to bear this evidence and other similar
 14 evidence in mind. When the OFT makes reference to
 15 Imperial instructing the retailers to adhere to specific
 16 price points, one needs to see that correspondence in
 17 context and set the correspondence in that context.
 18 What is happening invariably in those communications is
 19 that Imperial has been paying a bonus for a price
 20 reduction, the bonus is coming to an end, and so
 21 Imperial is informing the retailer in shorthand of that
 22 fact so that the retailer will want to put its price
 23 back up. It has nothing to do with being required to do
 24 something because Gallaher has done it, it's because we
 25 are no longer paying you and therefore this is what the

1 price should go back to.
 2 Of course they were perfectly free to leave the
 3 price down, but what Imperial didn't want to happen is
 4 that they should carry on being charged for a tactical
 5 bonus when they no longer wished that bonus to be
 6 provided because they no longer wished the product to be
 7 price cut.
 8 A lot of the correspondence that you will see
 9 relates to tactical bonuses being paid and withdrawn,
 10 and a lot of the correspondence therefore you have to
 11 see in the context of Imperial seeking to see that the
 12 bonus which it's providing for effecting a price cut is
 13 actually getting through and then, when it withdraws the
 14 bonus, making it clear that it no longer is requiring
 15 the price to be held.
 16 While we have Mr Batty's evidence, he makes this
 17 point at the previous paragraph on page 355:
 18 "The exact meaning of some of the ...(Reading to the
 19 words)... complex arithmetical calculations involved."
 20 The final point at this stage that I want to deal
 21 with, but we have already partially covered it, is
 22 Gallaher price changes and opportunity to respond
 23 clauses. We say that Imperial never sought to restrict
 24 the retailers from changing the retail price of another
 25 manufacturer's products in the event of a wholesale

1 price change by that manufacturer. That evidence or
 2 that submission is confirmed by the evidence of
 3 Fiona Bayley, which is worth turning up. I won't read
 4 it out, because I think that's covered by the
 5 confidentiality but it's in {C6, tab 69, page 440,
 6 paragraph 65}. We say that's absolutely right.
 7 Because the differentials in Imperial's trading
 8 agreements, because they were maxima, there was no
 9 requirement upon the retailers to increase the prices of
 10 Imperial products following a wholesale price increase
 11 by Gallaher. At the most, at the very most, the
 12 retailer could, if it chose, increase the price,
 13 providing it was maintaining the differential. But it
 14 didn't have to do so. But one of the things is when
 15 Gallaher put up its price and Imperial was holding its
 16 price, which is what happened in the summer of 2002,
 17 Imperial then actually did step in and say "We want to
 18 widen the differentials". But what that correspondence
 19 shows is there was no expectation on the part of
 20 Imperial that its price would go up because Gallaher's
 21 price had gone up, and what's more it's totally
 22 counterintuitive when you bear in mind what Imperial was
 23 trying to do, which was to undercut Gallaher. It had no
 24 desire to put up the retail price simply because
 25 Gallaher's price had gone up. Of course it could

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1 choose, if Gallaher put up its price, equally to put up
 2 Imperial's price. But that's just one manufacturer, who
 3 is affected presumably by the same cost factors,
 4 choosing at that time to put up its prices because it's
 5 able to do so, its competitor having done so. But it's
 6 nothing to do with the RMS arrangements.
 7 **DR SCOTT:** In that circumstance, where they have increased
 8 the price of the Gallaher brand --
 9 **MR HOWARD:** Yes. When you say "they"?
 10 **DR SCOTT:** The retailer. A retailer has increased the price
 11 of a Gallaher brand because --
 12 **MR HOWARD:** Gallaher has imposed a price increase.
 13 **DR SCOTT:** Provided they retain the differential, in other
 14 words that any subsequent increase in the Imperial price
 15 maintains the differential, they still get their bonus,
 16 as I understand it.
 17 **MR HOWARD:** That's right, but in other words, compare the
 18 situation without the RMS and with the RMS. Without the
 19 RMS the retailer may, where he sees one manufacturer put
 20 up the price, use that as an opportunity to increase his
 21 margins on the other manufacturers' products and put up
 22 the prices all the way, and say "Well, I am going to
 23 charge the same price". Where the RMS is there, he is
 24 in fact constrained in how much he would independently
 25 put up the price because if he puts up the price so he

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1 loses -- so the differential is no longer there, and you
 2 have to remember it's a maximum, then he would lose his
 3 bonus. But in fact he can earn his bonus either by
 4 maintaining at least that difference or he can leave the
 5 price where it is and it would be greater.
 6 **THE CHAIRMAN:** Unless he would thereby forfeit a bonus from
 7 Gallaher if there is a Gallaher agreement that the
 8 differential between that price and the Imperial price
 9 has to be not more than a certain amount. That's where
 10 we get to the parallel or symmetrical point. If
 11 Gallaher had said "Our brand must be priced not more
 12 than 3p more expensive than the ITL price" and then they
 13 put up their price, I know you say there the agreements
 14 didn't work in a way that would then require that
 15 retailer to increase the price of the ITL brand even
 16 though there had been no increase in the ITL wholesale
 17 price simply to enable Gallaher to maintain its
 18 differential, despite having put up its price. But it
 19 might be there that the obligation to raise the price of
 20 the ITL brand arises or doesn't arise, rather than --
 21 **MR HOWARD:** I'm focusing on the moment on any arrangement
 22 with Imperial, in other words it's got nothing to do
 23 with Imperial, unless you say, well, there is
 24 an arrangement which Gallaher has, firstly, where
 25 Gallaher has required that the price of Imperial must go

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1 up when they put up their price, irrespective of what
 2 Imperial does. Secondly, Imperial has to know about
 3 that, which we say we didn't, and so you are assuming
 4 some arrangement of which you are aware. But that
 5 may -- let's assume there was -- I mean, Gallaher, let's
 6 assume Gallaher had that arrangement. It doesn't go to
 7 the question of whether Imperial's arrangement is
 8 unlawful and whether Imperial has been engaged in
 9 anticompetitive conduct. It's only relevant if you are
 10 saying Imperial is actually somehow party to the
 11 arrangement whereby Gallaher is doing this. If it's not
 12 party to that and it's that Gallaher has imposed
 13 something on the retailer which Imperial is not party
 14 to, it has nothing to do with Imperial.

15 But if one looks at Imperial's arrangements, there
 16 Imperial's desire is to undercut Gallaher. So if
 17 Gallaher puts up its price and Imperial chooses not to
 18 follow, the last thing it wants is for its price to go
 19 up. If you think about that for a moment, because if
 20 it's not putting up its wholesale price, what benefit
 21 does Imperial get from its retail price going up, in
 22 other words from the retailer increasing its margin? It
 23 gets no benefit at all from that, that's going into the
 24 retailer's pocket. So it has no desire for its prices
 25 to follow Gallaher. The only way in which you can infer

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1 such a desire is if you say, well, really what's going
 2 on is a conspiracy between the manufacturers and the
 3 retailers to force prices up. Once you say, well, there
 4 is no evidence of that at all going on, and that is not
 5 actually -- the thing is, this is a case very much of
 6 willing to wound but afraid to strike. It is not a case
 7 where it is said there was a cartel between the
 8 manufacturers and here is the evidence that we rely on
 9 to support that. What they try and say is: oh, well,
 10 this is akin to it. You have then to ask: what exactly
 11 do you mean by that, because you are not saying there
 12 was any communication between the manufacturers, you are
 13 not saying they actually had parallel and symmetrical
 14 arrangements any more which were known about, just
 15 something similar. What actually is the case?
 16 **THE CHAIRMAN:** Is that a convenient moment? Finish off that
 17 point.
 18 **MR HOWARD:** This point would probably take a few more
 19 minutes.
 20 **DR SCOTT:** Just before you leave that point, from the point
 21 of view of the retailer, this is an opportunity to make
 22 an additional margin on Imperial cigarettes whilst
 23 retaining the bonus because they have retained the
 24 differential.
 25 From the point of view of Imperial, because of what

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1 we know about the relativity between the overall
 2 elasticity and the interbrand elasticity, Imperial isn't
 3 so concerned, providing that differential is maintained.
 4 Yes, it means that the retailer is making a greater
 5 margin, but there may be occasions when Imperial don't
 6 mind the retailer making a greater margin.
 7 But what you are missing, through that arrangement,
 8 is the pass-through, because the pass-through disappears
 9 if the differential is maintained but the Imperial
 10 retail price goes up.
 11 **MR HOWARD:** I don't think that's right, actually. It may be
 12 not to the same extent. If the retailer raises his
 13 margin, then the -- well, I suppose if you are saying --
 14 the net effect is the product is more expensive to the
 15 consumer.
 16 **DR SCOTT:** Yes.
 17 **MR HOWARD:** But I think one needs to stand back a little bit
 18 from this. Take a situation where there are no RMSs and
 19 one manufacturer puts up its price, the retailer may
 20 choose to adjust and so it puts up its wholesale price,
 21 and the retailer is adjusting the retail price of the
 22 Gallaher brand. The retailer may choose to use that as
 23 an excuse to put up the retail price of Imperial, even
 24 though Imperial's wholesale hasn't gone up.
 25 Now, insofar as the RMSs have any effect in that

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1 situation, they certainly do not require the retailers
 2 to put up Imperial's prices, they do not incentivise the
 3 retailers to put up Imperial's prices. All that they do
 4 is, in relation to the situation where they can put up
 5 the prices because Gallaher has done so, they limit the
 6 ability to put up prices. In other words, to say --
 7 it's very difficult to see how that could be
 8 anticompetitive when what you are still seeking to do is
 9 to keep Imperial's price down and to disincentivise the
 10 retailer from putting up Imperial's price when Imperial
 11 hasn't put up the wholesale price.
 12 There is nothing anticompetitive in that, it's
 13 entirely the opposite, it's pro-competitive. The way
 14 the OFT seeks to get it into a pro-competitive scenario
 15 is to say there is a requirement to put up the price,
 16 and there is absolutely none of that at all. The most
 17 you can say is that if you put up the price and maintain
 18 the difference, you won't lose your bonus, but that is
 19 simply saying that there is something that inhibits you
 20 putting up the price as much as you might in order to
 21 increase your margin. But something that inhibits the
 22 retailer charging more, as I say, is necessarily
 23 pro-competitive.
 24 **THE CHAIRMAN:** Shall we break there, Mr Howard?
 25 **MR HOWARD:** Certainly.

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1 **THE CHAIRMAN:** Thank you very much. We will come back,
 2 then, at five past 2.
 3 (1.07 pm)
 4 (The short adjournment)
 5 (2.05 pm)
 6 **MR HOWARD:** I am going to come in more detail later this
 7 afternoon, or first thing or some time tomorrow morning,
 8 to the way in which the agreements operated in the
 9 different conditions that one has to consider for the
 10 purposes of the theory of harm. So at the moment I am
 11 just looking at things in fairly general terms. So we
 12 were looking, before lunch, at the position where
 13 Gallaher puts up its price and Imperial hasn't put up
 14 its wholesale price. Is there anything in the
 15 agreements that requires the retailers, and that's the
 16 important thing, to put up the prices? And there is
 17 absolutely nothing. What's more, if the case was that
 18 Imperial was observing Gallaher price increases and was
 19 expecting its prices to be put up for some reason, one
 20 would expect to observe that in correspondence, which we
 21 say you simply don't. Equally -- well, I'll come back
 22 to some other scenarios.
 23 I want to now consider, which is where the
 24 opportunity to respond clauses fit in, the scenario
 25 where Gallaher reduces the price of one of its brands,

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1 ie effectively it's involved in price cutting activity.
2 Of course, part of the OFT's theory of harm is that
3 Gallaher is disincentivised from doing that, because it
4 can never get anywhere, essentially, putting it in very
5 simple terms.

6 Of course what you have to distinguish is
7 a competitive scenario where, if Gallaher reduces its
8 price, Imperial seeks to cut its prices and to gain
9 a competitive advantage. In other words, that's just
10 the normal workings of the market. From a situation
11 where the retailer is simply obliged to prevent
12 Gallaher, effectively, implementing its price cut. In
13 other words, if Imperial independently seeks to meet
14 Gallaher, there is nothing wrong with that, that's how
15 a market works, with people seeking to undercut each
16 other.

17 The opportunity to respond clauses appear in most
18 but not all of the trading agreements. They were
19 expressly included with the majority of the retailers
20 that's to say Morrisons, Sainsbury's, Shell, Somerfield,
21 T&S Stores and TM Retail. The important thing to note,
22 and shortly we will look at a couple of trading
23 agreements, is that these clauses do not give rise to
24 any obligation on the part of Imperial. In other words,
25 Imperial was not obliged to seek to match Gallaher's

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1 price reduction. They simply gave it an option. The
2 option, all it was in fact was an option to try to match
3 it, gave rise to no obligation on the part of the
4 retailer to accept what Imperial chose to do. In other
5 words, Imperial might come along and say "We want to
6 offer you a bonus, a higher bonus, or we want to try and
7 undercut and please accept some money". The retailer
8 would obviously then have to choose whether that was in
9 his interests, or whether if Gallaher was paying it more
10 money, whether it did or didn't accept what was offered.
11 In other words, there is just a further price
12 negotiation.

13 On the part of the retailers, the opportunity to
14 respond clauses gave rise to no obligation either.
15 That's in fact the evidence of Fiona Bayley of
16 Sainsbury, she says it didn't matter at all, and to
17 summarise her evidence, what she says is: if Gallaher
18 had a price promotion, we would reduce the price of
19 Gallaher. It was a complete indifference to us what
20 Imperial did. If they came along, having spotted it,
21 and sought to have their own price promotion, well, so
22 be it.

23 **THE CHAIRMAN:** What do you mean having spotted it, do you
24 mean without the retailer having complied with the
25 requirement to give notice?

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1 **MR HOWARD:** That's really what I am coming to. The question
2 is: was there any requirement at all on the retailer?
3 There is a possibility, one construction is that the
4 requirement on the retailer is to inform Imperial of
5 that, that there is a price promotion going on. That's
6 one possibility. The other is none at all.
7 Fiona Bayley's evidence is she didn't regard herself
8 under even an obligation to inform Imperial. That's
9 actually her evidence, that it was just if Imperial
10 spotted that the price had come down of Gallaher, they
11 might ring us up and say, "I want to try and put the
12 price of our brand down".

13 **THE CHAIRMAN:** Is Sainsbury's one of the ones where there is
14 an opportunity to respond?

15 **MR HOWARD:** Yes, absolutely. We will have a look at it.
16 They are not all in identical form. Let's be careful.
17 I do not want to get bogged down in this, because it's
18 not, as it were, the key point. One possibility is that
19 the opportunity to respond clause anticipates that the
20 retailer will contact Imperial. Now, in fact that
21 wasn't actually what happened, on the whole. On the
22 whole, it's Imperial watching like a hawk what is
23 happening in the retail stores, and it's Imperial which
24 would be proactive in saying "I see Gallaher's price has
25 come down, I want to try and match it" or not.

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1 Let's assume that actually the way the agreements
2 are supposed to operate as opposed to what actually
3 happened was that the retailer was supposed to say, "Do
4 you want to respond?" So what? It's not -- that's the
5 maximum obligation, which is to say to Imperial, "You
6 might like to respond to the fact that the price of
7 Gallaher is coming down and you might want to seek to
8 match it".

9 **THE CHAIRMAN:** So you say so what, because the level of
10 price transparency in a market is such that actually
11 being informed by the retailer was not necessary?

12 **MR HOWARD:** No, you see that, you saw it, that's why --
13 Imperial was employing lots of people. The case is, oh,
14 you were monitoring. Yes. Why do you think they were
15 monitoring? They are monitoring because they are
16 watching like hawks to see what the prices were,
17 including price promotions, which is a key part of this.
18 There is nothing wrong with monitoring that, and the
19 response in fact arose where they spot that a Gallaher
20 price promotion is going on.

21 So in fact there isn't any real distinction, you
22 will see, in the way things were operating in cases
23 where there was an explicit or express opportunity to
24 respond clause, and where there wasn't. Really, that's
25 because the opportunity to respond clause as a matter of

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1 obligation is adding either nothing or virtually
 2 nothing. The reason is, the most it adds is the
 3 obligation on the retailer to say to Imperial "Would you
 4 like to respond? You might want to respond", but it
 5 doesn't create any obligation going beyond that. There
 6 is no restriction on the retailer in the sense that,
 7 before he implements a Gallaher price cut, that he has
 8 to give Imperial the chance to respond and has to do
 9 what Imperial says, or anything of that sort.
 10 **DR SCOTT:** But if nothing happens, then presumably,
 11 according to the agreements, he loses the bonus based on
 12 differentials because a differential has been broken?
 13 **MR HOWARD:** No. Again, completely wrong. No, that isn't
 14 what happens at all.
 15 **DR SCOTT:** No, no, distinguish for a moment between what's
 16 in the agreement and what actually happens. I do
 17 appreciate that --
 18 **MR HOWARD:** No, the agreements are providing that -- sorry.
 19 Perhaps I answered too quickly. What the agreements are
 20 anticipating is that Gallaher may reduce prices as
 21 a result of a promotion. What the agreements then
 22 provide is that there is an opportunity to respond but
 23 the bonuses continue to be paid even if Imperial chooses
 24 not to respond and therefore the differentials have
 25 narrowed as a result of that, or there may not be any

1 differential. It could be Gallaher, previously Imperial
 2 was supposed to be below Gallaher; now it's actually
 3 above. The bonus may still be paid because the
 4 differential then would be based upon what the previous
 5 position was if Imperial doesn't respond.
 6 The retailer doesn't stand to lose his bonus as
 7 a result of the Gallaher price cut. The only
 8 circumstance he loses his bonus is if there is
 9 a Gallaher price cut, Imperial responds and he then
 10 chooses not to implement the Imperial response because,
 11 for whatever reason, he doesn't think it worthwhile.
 12 I think within what you said to me, there is
 13 a further point which could arise, never arose in
 14 practice, because this isn't how anything operated,
 15 where one could say: well, what happens if there is
 16 a Gallaher price promotion, the retailer says nothing,
 17 carries on pricing as he was previously, in other words
 18 the differential has widened; would he then lose his
 19 right to bonus because he had not given Imperial the
 20 opportunity to respond?
 21 **DR SCOTT:** That's my point.
 22 **MR HOWARD:** The thing is, that is theoretical and not real
 23 because nobody actually operated any of this on that
 24 basis, in the sense that Imperial knew exactly what was
 25 happening, so that the difference between whether you

1 have told them on Friday that Gallaher on Monday have
 2 a price promotion or you are discovering it on Monday
 3 didn't make any difference to anything.
 4 **MR SUMMERS:** Sorry, Mr Howard, may we just, again, since
 5 it's Day 1, be clear about this.
 6 **MR HOWARD:** Yes.
 7 **MR SUMMERS:** What you are suggesting when you use the words
 8 like "spotted" are that these promotions will only
 9 partly overlap with each other, because I think in the
 10 papers I seem to remember reading they take time to set
 11 up, they have to be spotted and then there have to be
 12 negotiations and things have to be printed and stock has
 13 to be organised to give effect to the promotion. So
 14 that inevitably manufacturer B will start their
 15 promotion later than manufacturer A, and presumably may
 16 go on for longer than manufacturer A.
 17 **MR HOWARD:** Sorry, I am not sure I'm quite there.
 18 **MR SUMMERS:** Shall we say Gallaher start, they cut, their
 19 promotion runs for a period of time, they decide when
 20 the length of the promotion is predetermined.
 21 Manufacturer B comes in, they start later than
 22 manufacturer A, Gallaher. Presumably their promotion
 23 can run on beyond the length of time.
 24 **MR HOWARD:** Yes.
 25 **MR SUMMERS:** Yes, and that's how it may --

1 **MR HOWARD:** That's how competition --
 2 **MR SUMMERS:** That's how competition works, and the duration
 3 of those promotion periods is a matter for discussion
 4 between the manufacturer and the retailer.
 5 **MR HOWARD:** And of course it's going to depend on -- the
 6 manufacturer may launch a promotion and he will have to
 7 decide how long he wants to maintain it. He may in the
 8 first instance launch it for a particular period, he
 9 finds it's particularly successful, and so he may extend
 10 it. It just depends upon what he is trying to achieve,
 11 which is presumably usually -- well, he is obviously
 12 trying to increase sales and increase market share.
 13 Obviously what happens, if you are Imperial, and
 14 this is very important to sort of just think about in
 15 the context of opportunity to respond. If you are
 16 Imperial and you see Gallaher -- I'm using Embassy and
 17 B&H simply because they are brands that we probably all
 18 just remember, easy to keep in your mind whose they are,
 19 they are not actually -- I use them for that reason --
 20 necessarily the best examples, because the brands where
 21 very heavy competition was taking place was actually
 22 Dorchester and Richmond in this ultra low price market,
 23 at least I always forget which was which so I'll stick
 24 to Embassy and Benson & Hedges.
 25 Let's assume for the sake of argument that the RRP

1 of Benson & Hedges was £4, and the RRP of Embassy is
 2 £3.97. They see that Gallaher is launching a promotion
 3 on B&H, and it's getting into the shops at £3.90 for
 4 sake of argument. Now, as in any situation, they have
 5 to say to themselves: do I want to try and undercut
 6 that, and they have to decide: how much is it going to
 7 cost me, because this is all going to come out of my
 8 margin which is rather limited, and do I think it
 9 a sensible thing, how long is Gallaher likely to do
 10 this? In other words, all sorts of things which are
 11 just market dynamics, where Imperial has no certainty or
 12 no knowledge of what Gallaher is going to do. So
 13 whether it responds depends upon its assessment of the
 14 market conditions and whether it's worthwhile.

15 What the opportunity to respond clauses explicitly
 16 make clear is that is what is going to go on here. In
 17 other words, there is no question of anybody being
 18 obliged to maintain differentials, it's simply that in
 19 the event that Gallaher does have a promotion, Imperial
 20 is essentially reserving the position to enhance the
 21 bonuses or its discounts in order to preserve the
 22 position, and that's all it's saying, and nothing more
 23 than that.

24 We do say that the opportunity to respond clauses,
 25 one could respond without those clauses, and that's the

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1 important point, but the fact that the clauses are there
 2 in the majority of the cases illustrates how far
 3 off-beam the OFT case is when we come to look at its
 4 assertions that there was this lock-step requirement or
 5 anything of that sort.

6 The opportunity to respond rather picks up a point
 7 we were discussing this morning, they underline the fact
 8 that the differentials were based on essentially the RRP
 9 differences and were necessarily subject to changes in
 10 the wholesale price.

11 Now, of course to pick up a point that was made this
 12 morning, one can seek to infer what the wholesale price
 13 is. You can't actually necessarily know what the
 14 precise terms are on which the product is being sold by
 15 Gallaher to the retailer. You can infer quite a lot.
 16 But the real point of the opportunity to respond clause
 17 is that what you are trying to do is, where you find
 18 that the differentials are not being observed, it allows
 19 the retailer to say to you: ah, well, there is
 20 a promotion going on from Gallaher. What you won't
 21 actually know is whether they are necessarily telling
 22 you the truth about that, and that's what is referred to
 23 by in fact Professor Shaffer in his 2007 report as
 24 a retailer -- parlaying is the word he uses the
 25 manufacturers to use this as an opportunity to negotiate

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1 lower prices.

2 That actually goes back to the point that you were
 3 asking me: do you actually know what the wholesale price
 4 is? You don't, so that the retailer can sometimes say
 5 to you: look, when you say, well, I wanted to
 6 incentivise you to price me at least 3p below Gallaher,
 7 he can say, well, you know, Gallaher are paying me money
 8 to be at this price, of course it's up to you whether
 9 you want to try and pay me a bit more. In other words
 10 they try and set one off against the other. That's part
 11 of, again, a competitive environment where you don't
 12 have absolute clarity of what's going on.

13 **DR SCOTT:** Sticking with the clarity point, presumably from
 14 Imperial's observation, what happened when they put in
 15 a price promotion, they would draw deductions about
 16 whether there were any price response clauses in any
 17 agreements that Gallaher might have.

18 **MR HOWARD:** Again, I don't think that follows at all. The
 19 conclusion doesn't follow from the premise. The fact
 20 that Gallaher responds with a price cut doesn't tell you
 21 whether they are doing it because they have
 22 an opportunity to respond clause or not. Because the
 23 opportunity to respond clause doesn't actually add
 24 anything to the competitive motivation to try to
 25 undercut. At most, it simply is somebody alerting you

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1 to something which actually you discover anyway. So if
 2 Imperial puts down its price and it sees Gallaher try
 3 and then engage in rival price cutting, if you say what
 4 can you infer from that, simply that Gallaher is
 5 concerned that we are going to eat into its market share
 6 and so it's responding.

7 **DR SCOTT:** Yes, I suppose the difference is between that
 8 which is observable in the open market and that which is
 9 a declaration of the price intention, in other words
 10 fore-knowledge?

11 **MR HOWARD:** Sorry?

12 **THE CHAIRMAN:** It's whether the opportunity to respond
 13 clause means that Imperial gets advance notice before
 14 the Gallaher price cut is implemented which enables it
 15 then to bring in its own response sooner than it would
 16 if it was relying on just driving around happening to
 17 see it in the ...

18 **MR HOWARD:** Yes. But that isn't actually the case, as to
 19 what was happening, and in order to -- the thing is, (a)
 20 that is not what was happening, but let's just assume
 21 for a moment that that was. It still doesn't have the
 22 anticompetitive object which is being addressed by the
 23 OFT, because the question -- let's assume Imperial is
 24 getting advance warning that there is a Gallaher price
 25 reduction. Imperial then will have to choose whether or

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1 not it wishes to respond to that.
 2 Now, the question is: is it any more likely that
 3 it's going to respond simply because it's received
 4 advance notice than the situation where it responds when
 5 it sees the position itself? Then you have to say --
 6 you have to remember this is where it has to lead, even
 7 if you say well, it may make it a little bit more likely
 8 or even a lot more likely, you then have to say, wait
 9 a minute, what does that mean, it means prices are
 10 coming down. So then you have to say oh well, the fact
 11 that Imperial in that situation is putting its price
 12 down, somehow is going to lead to a situation where
 13 prices are going to go up.
 14 Now, you can see the basis of a theory where you say
 15 whenever Gallaher's price comes down, Imperial's price
 16 automatically comes down, that Gallaher is
 17 disincentivised. Where you are in a different situation
 18 where you are saying Imperial may or may not respond,
 19 what is the effect there and why does that necessarily
 20 lead to Gallaher being disincentivised. Look at the
 21 current market. There are price promotions still going
 22 on. If Gallaher tomorrow reduces its price, Imperial
 23 may or may not respond.
 24 What you can say is true is that a situation can
 25 arise in any market, particularly in a more concentrated

1 market, where you get severe price cutting and after
 2 a while, independently, both manufacturers or suppliers
 3 come to the conclusion that this game isn't worth the
 4 candle, and they just don't bother. To some extent you
 5 can see that, I am not giving this, as it were,
 6 an example, I haven't conducted an investigation. But
 7 we all know that in, say, the newspapers, there have
 8 been times where the red tops have engaged in severe
 9 price cutting and then you get to a period where nothing
 10 seems to be happening and the prices all seem to be the
 11 same. That's presumably because they come to the
 12 conclusion that it simply is not achieving very much and
 13 every time I reduce my price he reduces his price. But
 14 that's a different factor and a different circumstance
 15 to that with which this case is concerned.
 16 Let's look now at two examples of the trading
 17 agreements, and then it's important that we come on to
 18 the theory of harm.
 19 Quite a lot of the discussion we had is obviously
 20 relevant but it is divorced from the theory of harm and
 21 it is very important to see exactly what this theory is
 22 and how it fits together with what we have discussed.
 23 I'm showing you two, as I say. No doubt the
 24 retailers when they do their openings will probably show
 25 you them, and when I have my mini opening at each appeal

1 I will go into it much more. I ought to say I am not
 2 this afternoon going to have time to look at all the
 3 correspondence that the OFT relies on. I will try and
 4 look at one or two letters to show that they simply do
 5 not fit in with the case that's sought to be made.
 6 The first example that we could go to is in the case
 7 of Morrisons, and could you take SO annex 17.
 8 There are two ... Sorry.
 9 **DR SCOTT:** We are just working out the different numberings.
 10 **MR HOWARD:** It is a nightmare, but I suspect by
 11 December 21st we will have mastered it, I doubt much
 12 before then.
 13 For your note, there are two trading agreements.
 14 The first is at tab 4 and the second is at tab 45.
 15 Actually there are three. There is one at tab 45 and
 16 there is another one at tab 85, I think. Although that
 17 may be an amendment. Yes, tab 85.
 18 Tab 45 extends the one at tab 4, and then tab 85 is
 19 for a later period from 2002 to 2004.
 20 Going back to tab 4 -- I don't know the extent to
 21 which the Tribunal has had, I imagine you have had
 22 an opportunity to look at these agreements. One of the
 23 things that is clear is that these are very shorthand,
 24 they are certainly not models of commercial drafting,
 25 I am sure my clients will forgive me for saying that,

1 and they are a little bit cryptic sometimes.
 2 You can see that on page 1 it was from 1999 to 2001,
 3 and you can see that the provisions, if you go to
 4 pages 2 and 3, are covering a number of things. So you
 5 have pricing, distribution availability, merchandising
 6 and advertising. The strategy pricing sheet is on
 7 page 5. You will note on pages 6 and 7 are what's
 8 called range requirements in the stores.
 9 So going back to page 2:
 10 "ITL agree to maintain levels of off-invoice bonuses
 11 provided ITL prices are in line with our current
 12 strategy. No change in level of bonus on [two
 13 particular ones]. If our pricing strategy changes,
 14 Morrisons to be notified and a new price issue will take
 15 effect. Morrison to confirm instore promotional
 16 activities which may affect pricing strategy. ITL agree
 17 to maintain bonus levels in line with appendix 1, should
 18 we elect not to respond to other manufacturers' pricing
 19 initiatives. ITL will retrobonus [and so on] non-200
 20 multipacks."
 21 I don't need to read out the other aspects. The
 22 incentive bonus, you can see it, firstly, it's perfectly
 23 clear that what is being paid is an incentive bonus,
 24 provided ITL prices are in line with current strategy.
 25 That strategy is set out on page 5, which lists the

1 differentials.
 2 As you can see, just casting your eye down there,
 3 the brands which were the subject of this are generally
 4 one sees maxima price differentials, but in one or two
 5 cases you have Superkings family for instance, "level
 6 with on".
 7 If you look at the context of this, it's perfectly
 8 clear that ITL doesn't have a requirement that
 9 Superkings must be priced at the same price as Berkeley,
 10 B&H, Superkings and Raffles, but "level with on" is
 11 intended here to mean that it mustn't be more expensive
 12 than. There is absolutely no rationale for suggesting
 13 that ITL was trying to require Morrisons to price at
 14 parity. Their concern was always ensuring that at least
 15 the differential was maintained. That point is
 16 confirmed by Mr Eastwood of Morrisons at paragraph 16 of
 17 his evidence, which is in core 8, tab 94, page 436.
 18 Come back to the opportunity to respond clause. If
 19 you would turn to tab 85, this is the agreement that was
 20 in place from 1 August 2002. It is in slightly --
 21 **THE CHAIRMAN:** Just going back to that, then, was that
 22 an agreement in which there wasn't also one of these
 23 bonuses for pricing below RRP, or would that have been
 24 in a different agreement?
 25 **MR HOWARD:** I am not sure about that.

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1 **THE CHAIRMAN:** So how this worked, then, just so
 2 I understand it, is that, looking at page 2, you have
 3 the factors or the parameters in 2, 3 and 4, there are
 4 specific sums mentioned and then number 1, the relative
 5 pricing, that is ...
 6 **MR HOWARD:** Are you asking, what is the level of bonus?
 7 **THE CHAIRMAN:** That's what's set out on page 4, is it?
 8 **MR HOWARD:** Yes.
 9 **THE CHAIRMAN:** Page 4 is the appendix 1, so it's those
 10 numbers, those pence per pack sold, provided that you
 11 stick with the pricing sheet on page 5.
 12 **MR HOWARD:** That's right.
 13 You can see generally it's pretty low.
 14 **DR SCOTT:** What you are saying is that whereas in 1 on
 15 page 2 there is a reference to response, there isn't in
 16 there a provision which says "Inform us if this has
 17 happened".
 18 **MR HOWARD:** Absolutely. So if you take this agreement, you
 19 would have to say, well, it must be implicit in here
 20 that Morrisons have to tell Imperial, that's absolutely
 21 hopeless if that's what's being said, we could go into
 22 the law on implied terms, but to suggest such an implied
 23 term would be a very, very tall order.
 24 This isn't providing anything about Morrisons doing
 25 anything, it's just that ITL is agreeing to maintain the

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1 bonus levels, should we elect not to respond to other
 2 manufacturers' pricing initiatives.
 3 **DR SCOTT:** So if in practice Morrisons adopt a Gallaher
 4 pricing initiative, and then Imperial come back and say
 5 "Hold on a moment, you are not working by the page 5
 6 differentials", Morrisons can say "Yes, but we have
 7 a Gallaher pricing initiative and therefore you must go
 8 on paying the bonuses if you don't respond".
 9 **MR HOWARD:** Yes, that's right, it's just the reason these
 10 are not models of drafting, in the sense that it doesn't
 11 fully explain, well, what -- assume there is a Gallaher
 12 price initiative and the price therefore of the Gallaher
 13 product has gone down, Imperial shrugs their shoulders,
 14 what is it that Imperial is expecting Morrison to do in
 15 order to earn the bonus? What it's expected to do is to
 16 continue to price on the prior basis, before the
 17 Gallaher price promotion. So that in other words if,
 18 maintaining the differential had meant it was pricing
 19 Embassy at £3.90, if it carries on pricing Embassy at
 20 £3.90, notwithstanding the fact that B&H is in at £3.87,
 21 they have still earned their bonus.
 22 You might think, well, that's commercially a little
 23 bit odd, but it's not really because even in that
 24 situation Imperial is concerned to ensure that it
 25 doesn't get unfairly prejudiced, for instance by the

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1 margin being put up or whatever it is, so it still comes
 2 back to this point that there are the two drivers, one
 3 is to try and ensure that the low wholesale price gets
 4 reflected in the retail price with the retailers not
 5 seeking to earn excessive margins at Imperial's expense,
 6 but secondly trying to maintain the differential with
 7 Gallaher. That's the key point. But sometimes you
 8 can't do that because Gallaher are price cutting and
 9 it's just not worth -- or Imperial doesn't want to spend
 10 the money.
 11 **THE CHAIRMAN:** Do these sort of temporary promotional
 12 efforts feed in at any stage, either immediately or over
 13 time, to the RRP's?
 14 **MR HOWARD:** The answer is it all depends. Where
 15 a manufacturing price increases, that generally will
 16 change the RRP. Where you have a temporary promotion,
 17 that will not necessarily cause any change in the RRP.
 18 Now you might say, hang on, what about the Treasury
 19 position, how is that working? The answer is that -- we
 20 may have to look at this a little more closely in the
 21 light of some of the questions about it, so subject to
 22 that caveat, I'll explain how I understand it to work.
 23 Where there is a price promotion, firstly your RRP
 24 may still represent what you anticipate to be the
 25 average selling price, notwithstanding the promotion.

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1 Secondly, of course, the Treasury isn't losing any money
 2 if you reduce your price. In other words, the tax you
 3 have to account for will be based upon the RRP. So if
 4 you get into a situation where you have said the RRP for
 5 Embassy is £4, if actually in the following period it is
 6 generally being sold for the sake of argument at £3.80,
 7 the manufacturer will then be in a position where he has
 8 to account to the Revenue for more tax than would
 9 otherwise be due. So --

10 **THE CHAIRMAN:** I think we are probably asking a simpler
 11 question, which is, when one talks about a promotional
 12 initiative, then you are only talking about a change in
 13 the wholesale price, it's not brought about by a change
 14 in the recommended -- or doesn't automatically give rise
 15 to a change in the retail -- in the recommended retail
 16 price.

17 **MR HOWARD:** What you are doing with promotional activity, in
 18 all cases, is that the retailers are not going to bear
 19 the cost, it's all manufacturer driven. So it's
 20 manufacturer trying to get enhanced sales. So he cuts
 21 his wholesale price, but he wants to ensure that that is
 22 fed through. So by one means or another, he pays money
 23 to the retailer, which is a reduction in the wholesale
 24 price, but the retailer, he doesn't want to use it to
 25 increase his margin, and it goes through to the

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1 consumer.
 2 There is no secret in it, that's obviously what both
 3 manufacturers want to do when they are trying to promote
 4 price, and they have to do that because they lack the
 5 confidence that the retailers will pass it through, and
 6 that's not necessarily peculiar to the tobacco industry,
 7 but they were factors which exacerbated the problem.

8 Back on pages 2 and 3, of course what you can see is
 9 that this is part of a general arrangement to
 10 incentivise promotion of the products. Equally, what
 11 one sees is that it's perfectly clear that the bonuses
 12 cannot on their face be requiring that if Gallaher puts
 13 its price down, that the retailer is required to do
 14 anything, otherwise you can't make any sense of that
 15 sentence.

16 Equally, there is nothing here which provides that,
 17 in the event that Imperial puts up its prices, the
 18 retailer is then required to do anything. The reason
 19 for that is of course that, when you put up your price,
 20 it would be a very strange thing to find in the trading
 21 agreement some obligation to affect the retailer's price
 22 of Gallaher, particularly where -- this is a very
 23 important point to understand -- if the retailer were
 24 obliged, if Imperial announces a price increase, to put
 25 up the price of Gallaher where there is not a Gallaher

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1 price increase, the retailer runs the risk that it will
 2 then be at an adverse competitive position to the other
 3 retailers selling Gallaher products. So if we take
 4 Tesco, who are not alleged to be party to any of these
 5 arrangements, Tesco's price for Gallaher will stay the
 6 same if Gallaher hasn't had a price increase. So why on
 7 earth would the retailer be for these sums of money
 8 willing to prejudice itself as against Tesco?

9 **DR SCOTT:** Except that there isn't a concomitant provision
 10 in one to deal with a situation where ITL institute
 11 an MPI. So if ITL institute an MPI, there is not
 12 a provision which says your bonuses will continue to be
 13 paid unless you sustain the differential with Gallaher.
 14 If Imperial go up, then if you want your bonuses to
 15 stay, the differential with Gallaher has to be restored.
 16 So Gallaher has to go up.

17 **MR HOWARD:** There isn't a provision saying that.

18 **DR SCOTT:** There isn't a provision saying that you still get
 19 the bonus even if you don't do that with Gallaher
 20 (indicated).

21 **MR HOWARD:** The agreement in fact doesn't address the
 22 position where there is a unilateral price increase by
 23 Imperial.

24 **DR SCOTT:** That's right.

25 **MR HOWARD:** It's silent. So you have to remember, what we

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1 are always looking for is a restraint of some sort. So
 2 did this agreement impose a restraint on the retailer so
 3 that, if Imperial chose to put up its prices, that
 4 imposed some requirement or obligation on the retailer
 5 to put up the price of the Gallaher product, or at least
 6 provide such an economic incentive to him that
 7 effectively he was restrained? The answer to that is,
 8 we would suggest, it's perfectly clear that this
 9 agreement is simply not seeking to address that
 10 situation. The reason for that is, it says nothing, it
 11 doesn't make any economic sense to think that the
 12 retailer is going to bind itself to put up the price of
 13 Gallaher where simply because Imperial has put up the
 14 price of its product, when in doing so the retailer will
 15 competitively disadvantage itself against its
 16 competitors, against whom it's benchmarking itself. The
 17 only circumstance in which you could envisage it would
 18 do this is where it's being paid a very significant sum
 19 of money.

20 **DR SCOTT:** Or if it's in a situation where it is receiving
 21 either an explicit or an implicit assurance that other
 22 retailers are likely to behave in a similar way.

23 **MR HOWARD:** Firstly there is no evidence to suggest that.
 24 We have to be careful. One can postulate all sorts of
 25 things. It's rather like Professor Shaffer and the OFT

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1 postulating that, well, if they were paid lump sums then
2 they might be prepared to do this. The answer is, well,
3 yes, you can postulate that, but were they? The answer
4 is nobody suggests they were.

5 **THE CHAIRMAN:** At the moment we are just looking at the
6 trading agreement, and what you are saying is that even
7 though one can see on page 5 that one might think that
8 this means that if Lambert & Butler is put up by 2p,
9 that the obligation or incentive to price Lambert &
10 Butler not more than 10p more than Sovereign means that
11 they would have to put up Sovereign's price by the same
12 amount.

13 **MR HOWARD:** Yes.

14 **THE CHAIRMAN:** And you are explaining why, even though the
15 agreement doesn't contain a sort of converse of what's
16 written there about electing not to respond to other
17 manufacturers' pricing initiatives, in fact you say,
18 well, it can't have been expected to work like that
19 because if the retailer was going to put up the price of
20 Sovereign then other retailers weren't going to put up
21 the price of Sovereign, then they would suffer a loss
22 far beyond any bonus they could have hoped to get from
23 ITL.

24 **MR HOWARD:** That's right. We would suggest it's utterly
25 obvious it doesn't work in that way, because you cannot

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1 envisage commercially that that is what these retail
2 would do. You can't envisage that, for instance, Asda
3 were agreeing that, well, if you, Imperial, put up the
4 price, I am going to have to put up the price of
5 a competing product where my rivals are not doing that.
6 I agree, the only basis on which you can get there is
7 either if you say, well, within these agreements you are
8 paying such a significant sum of money that it's worth
9 your while, but everybody accepts these sums of money
10 are for that purpose utterly trifling, so it's not that.
11 Or if you postulate, well, there must be some
12 understanding that everybody else is going to do the
13 same, that would require -- that case isn't being, at
14 least I don't understand that case is being run; if it
15 was, one would have to look very closely at the
16 evidential basis for it. That isn't the parallel and
17 symmetrical case, which has now gone to be a similar
18 case, it's actually: and we have the agreement with
19 Tesco.

20 But the difficulty with that case, even if you say
21 somebody has that assurance, if in fact you have not got
22 the agreement with Tesco, then it would straightaway be
23 observed that Tesco aren't putting up the price of
24 Gallaher and there hasn't been an MPI by Gallaher, so
25 what's going on?

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1 So it doesn't work, particularly in an environment
2 where not only is it perfectly clear I would suggest
3 that nobody actually trusts each other in relation to
4 that sort of comment, but actually they are all very,
5 very keen, particularly the supermarkets, in
6 competition.

7 The other point is this -- again, I was going to
8 come to it later but I'll deal with it now. What you
9 will observe in the documents is that from time to
10 time -- in relation to all of these retailers --
11 Imperial announces an MPI. It says "I am putting up the
12 price". Then what you find is they say "But, hold it,
13 please, because I want to see -- essentially this is the
14 message -- what Gallaher are doing". In other words,
15 although they have announced an MPI, they bear the cost
16 themselves and they don't pass it on directly to the
17 retailer.

18 Now, that would be completely nonsensical if they
19 had an arrangement with the retailer or an expectation
20 as a result of these arrangements that the retailer
21 would be putting up Gallaher anyway.

22 Indeed, what you would expect to find during the
23 period of 2000 to 2003, if there was this expectation,
24 that prices would be being pushed up through that
25 period, because the manufacturers would have had

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1 an opportunity to push up prices, confident in the
2 knowledge that their rival prices by one means or
3 another, with certainty, will come up. When you look
4 actually at the data, the data doesn't show that at all,
5 the period after the alleged infringements stop,
6 actually, if anything, shows greater price increases
7 than during this period, and certainly greater
8 volatility.

9 Sorry, there was greater volatility during the
10 infringement period than after.

11 I think that probably exhausts that agreement, and
12 we can go to tab 85, just to see the subsequent year's
13 one. The point in this one is that it's not actually
14 done on the same basis, so what they do is they pay
15 a lump sum to Morrisons for doing a whole lot of things.

16 So it was [redacted] --

17 **THE CHAIRMAN:** Those are supposed to be confidential, those
18 figures.

19 **MR HOWARD:** I am sorry, I beg your pardon.

20 **THE CHAIRMAN:** It's not me you should be apologising to.

21 **MR HOWARD:** I apologise to whoever's --

22 **THE CHAIRMAN:** It is not marked up in your --

23 **MR HOWARD:** It is, but in my excitement, I forgot.

24 **THE CHAIRMAN:** Perhaps we can just put those figures in
25 square brackets ultimately in the transcript.

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1 **MR HOWARD:** I am sorry, and if I have been doing that on
 2 other occasions I will try to remember.
 3 So the format of this agreement is slightly
 4 different in the sense that what you have is a single
 5 payment for the various things, so you can see the first
 6 thing was product listing and availability. Over the
 7 page is -- I don't need to go into the detail, you can
 8 yourselves see that there are a lot of different things
 9 going on. You then have pricing and merchandising.
 10 You can see in relation to pricing that the
 11 differentials now are absolutely clearly maxima and we
 12 suggest, there is no change between the years and it was
 13 obvious at all times that was the case.
 14 The opportunity to respond -- well, if you look
 15 under "Pricing", you can see the opportunity to respond
 16 clause:
 17 "Should our competitors reduce their shelf prices,
 18 Imperial Tobacco should be allowed to respond in order
 19 to realign with the price list differentials. Should
 20 any additional funding be agreed to support a response
 21 to competitor activity, it should be removed once that
 22 activity has ended."
 23 Again, that sort of statement is really only
 24 a statement of the obvious, so that if we choose to
 25 fund, in order to support a response to competitor

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1 activity, when that activity ends, then it can be
 2 removed. In other words -- and this is what you will
 3 find in the correspondence -- they support a price
 4 reduction and then remove it once the reduction ends.
 5 Unless you have any questions on that, I was then
 6 going to turn to the Sainsbury one.
 7 **MR SUMMERS:** May I just ask, again it's another Day 1
 8 question, it does come up again: what is understood by
 9 natural price list differentials in the pricing section,
 10 line 2?
 11 **MR HOWARD:** What is being referred to there is the -- the
 12 word "natural" is obviously, to people not involved in
 13 this, a slightly odd word -- price list differentials
 14 that one observes in the RRP's. In other words, that's
 15 what you have to remember is very important, that
 16 historically brands have competed -- maybe this isn't
 17 particularly odd -- but historically the manufacturers
 18 have always sought -- whether always, but in recent
 19 years they have sought to compete with one brand matched
 20 against another, and so then in the RRP's you see where
 21 each of them is trying to price vis-a-vis the other
 22 their brand. That's what they are referring to as the
 23 natural price list differentials.
 24 **DR SCOTT:** I think Mr Batty refers to this in his
 25 paragraph 4.37 in his first ...

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1 **MR HOWARD:** Sorry, who does?
 2 **DR SCOTT:** Mr Batty.
 3 **MR HOWARD:** Yes. I was worried from the way you mentioned
 4 it that I had got it wrong, but I don't think so.
 5 **DR SCOTT:** I think that's right.
 6 **MR HOWARD:** It is broadly consistent with that. "Natural"
 7 is simply reflecting the fact of the way in which the
 8 manufacturers individually are setting(?) themselves.
 9 Sorry, I overlooked, and I should have done, that on
 10 page 463 in the Morrisons agreement, after the
 11 opportunity to respond clause is the provision that:
 12 "With the exception of the application of either
 13 Budget or manufacturer price increases, Imperial Tobacco
 14 investment should reduce in line with any upward
 15 movement in shelf price."
 16 What that was concerned with is the situation where
 17 the, other than where you had Budget or manufacturer
 18 price increases, where the retailer was seeking to move
 19 prices up. That would be as a result of a, one would
 20 infer, Gallaher price increase, the retailer pushing up
 21 the price. In other words, it was making it clear that
 22 if, as a result of your retailer decision to put up
 23 shelf prices, then we are not going to pay in the event,
 24 again, that our differentials thereby are reduced. In
 25 other words, it's making it clear that we are not

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1 expecting you to put up the prices, and insofar as you
 2 do and the differentials are reduced, then we are not
 3 going to be paying you the bonus.
 4 Can we then go quickly to Sainsbury's in SO
 5 annex 18, tab 17, you will see on the first page this is
 6 what's described as a copy of the trading agreement, and
 7 just if you turn the pages you will see it's covering
 8 various different things. The relevant part for present
 9 purposes is on -- I can't read the pagination in mine,
 10 but there is a slide which is "Prices", about halfway
 11 through.
 12 (Pause)
 13 **DR SCOTT:** It looks like that? (indicated)
 14 **MR HOWARD:** Yes, exactly.
 15 **THE CHAIRMAN:** That's 37.
 16 **MR HOWARD:** It must be 37, yes. So you can see:
 17 "Price differentials maintained between ITL and
 18 competitor brands where appropriate. Bonuses to be paid
 19 based on selling price. ITL to be able to respond to
 20 any price promotions where appropriate within
 21 a reasonable timeframe."
 22 Now, on the very last page of this section is the
 23 price list differentials, and you can see that way that
 24 this was expressed -- again it's all in very shorthand
 25 terms -- is if you take B&H Kingsize, that's minus 3p

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1 against for Embassy No 1 Kingsize, and so on. From
 2 this, the OFT infers that or concludes that the price
 3 difference was to be fixed at minus 3p, whereas in fact
 4 when you think about it for a moment, it's utterly
 5 obvious that where they write minus 3p, what they mean
 6 is at least minus 3p. There is absolutely no reason why
 7 Imperial requires the price of Embassy to be precisely
 8 3p less. Its purpose is achieved by it being at least
 9 3p, and there is nothing in the agreement that says it
 10 has to be fixed at that differential and no more, and we
 11 would suggest it's obvious that it's intended to be at
 12 least that.

13 The bonus rates are set out in schedule 2, and these
 14 bonuses are per 1,000 sticks. In case you thought that
 15 looks rather a lot for a packet of 20, it's the bonus
 16 per 1,000 sticks.

17 Again, going back to the opportunity to respond
 18 clause, you can see it doesn't create any obligations at
 19 all, "ITL to respond where appropriate within
 20 a reasonable timeframe." It doesn't have any obligation
 21 on the retailer to do anything.

22 There is then an agreement for the later year at
 23 tab 61. In relation to pricing on the second page, you
 24 can see under "Pricing" -- well, you can see again the
 25 agreement does various things, but pricing:

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1 "SSL [Sainsbury's] accept that ITL make investments
 2 in their brands based on two fundamental criteria: shelf
 3 price relativities and the absolute levels of those
 4 shelf prices and the pricing strategy is to replicate
 5 the differentials that exist naturally between our
 6 brands and those of our competitors."
 7 Those are set out in appendix 5.
 8 "Based upon the shelf prices and the achievement of
 9 the price list differentials, ITL will continue to pay
 10 the bonuses framed in the example price panel."
 11 Then it is explained:
 12 "The investments consist of two elements: ongoing
 13 and tactical bonuses, both paid retrospectively."
 14 Just stopping there for a moment, the tactical
 15 bonuses are where you specifically go in to try to
 16 ensure that the price of a particular brand is priced at
 17 a low level, so that's why it's called a tactical bonus.
 18 There is a danger, the OFT seeks to confuse the tactical
 19 bonuses and the bonuses to achieve the shelf price
 20 relativities, but here you can see very clearly they are
 21 not the same.
 22 Then it's provided that:
 23 "Ongoing bonuses will be paid based on SSL's shelf
 24 prices remaining at their current levels and should be
 25 reduced in line with any upward movements excluding MPI

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1 or Budget increases."
 2 So that is a similar provision to that which we
 3 found in the Morrisons one, which is reflecting the
 4 position that things will change if the shelf prices go
 5 up, excluding as a result of MPI or Budget increases.
 6 "Tactical bonuses are paid to reflect additional
 7 investment, usually in response to temporary or
 8 sustained competitor activity, and should also be
 9 reduced once that activity has ended. From time to
 10 time, ITL's competitors may reduce the shelf price for
 11 their brands. SSL should allow ITL the opportunity to
 12 respond in order to realign with the differentials.
 13 Should ITL choose not to respond, those differentials
 14 may widen."

15 There is nothing in here where one sees any
 16 obligations on Sainsbury's to affect the Gallaher price
 17 or to affect ITL's price where Gallaher has put its
 18 price down.

19 Now, that's probably a convenient moment for our
 20 break, and moving on to the theory of harm.

21 **THE CHAIRMAN:** Thank you very much. We will break for 10
 22 minutes, so we will come back at 25 past 3.

23 (3.15 pm)

24 (A short break)

25 (3.25 pm)

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1 **MR HOWARD:** Just before we move into the theory of harm, can
 2 I just make a couple more points on Sainsbury's. One
 3 point I think I misled you about in relation to both
 4 Sainsbury's and Morrisons, where I made a point against
 5 myself, and if you could take annex 18 and go back to
 6 tab 61, do you remember that pricing on the second page
 7 provided that:

8 "The pricing was dependent upon two fundamental
 9 criteria: shelf price relativities and the absolute
 10 price of levels of those shelf prices."

11 Then under "Ongoing Bonuses" it was provided that:

12 "They would be paid based on SSL shelf prices
 13 remaining [obviously 'at'] their current levels and
 14 should be reduced in line with any upward movements,
 15 excluding MPI or Budget increases."

16 So that in fact the way this and the Morrisons
 17 agreement operated, if Gallaher introduced an MPI which
 18 wasn't followed by Imperial, and if Sainsbury's here or
 19 Morrisons in theirs put up the price at all of
 20 Imperial's product, then their bonus was to be reduced.
 21 In other words, it wasn't only a question of maintaining
 22 the differential, it was also if you put up the prices
 23 at all where we haven't put up our prices or it's not as
 24 a result of a Budget increase, then your bonus would be
 25 in jeopardy.

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1 So --

2 **THE CHAIRMAN:** You read "excluding MPI or Budget increases"

3 as meaning excluding Imperial MPI or Budget increases,

4 not either Imperial or Gallaher?

5 **MR HOWARD:** Absolutely. It doesn't make any sense at all to

6 read into that excluding Gallaher MPIs.

7 It's talking about Sainsbury's shelf prices for

8 Imperial products. There is nothing here where you can

9 say what they are talking about is Sainsbury's shelf

10 prices for Gallaher products. Imperial simply were --

11 I was going to say, but again I would be making a point

12 against myself, Imperial couldn't care less if

13 Sainsbury's put up the price of Gallaher products. They

14 are delighted if Sainsbury's put up the price of

15 Gallaher products, because what they want is Sainsbury's

16 then to hold their prices at the pre-existing shelf

17 prices enhancing their competitive position.

18 The other thing I wanted to turn up was

19 Fiona Bayley's witness statement, which is in fact --

20 I didn't expressly refer to it because I was concerned

21 it was confidential, but the actual witness statement

22 isn't, and that's in volume 6 of the core bundle at

23 tab 69. {C6/69/442}

24 **DR SCOTT:** Are you wanting us to keep the Sainsbury's

25 agreement?

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1 **MR HOWARD:** Because she is referring to it, you might want

2 to, but it's not necessary. It's paragraph 78 on

3 page 442 of the bundle. She refers to the 2002 trading

4 agreement and quotes from it, and then says:

5 "This means that if we implemented a tactical price

6 move for a competitor, Imperial would see this price hit

7 the shelf and want an opportunity to respond. I would

8 not initiate this. Imperial would say 'well, you have

9 reduced the price of Dorchester, can we do the same on

10 Richmond? Paul and I would normally have a telephone

11 conversation confirmed by email."

12 So in other words, the Sainsbury's buyer understood

13 the position to be exactly as we have said, which is

14 that she was free to accept for Gallaher to promote the

15 price and she was free to accept for Gallaher to provide

16 a tactical bonus. That of itself had no effect

17 whatsoever on Imperial, but in that event she would not

18 do anything vis-a-vis contacting Imperial, simply if

19 Imperial spotted the position then they would ring up

20 and you would have a discussion to see whether or not

21 Imperial wanted to themselves fund a price cut. All of

22 that is entirely pro-competitive behaviour.

23 Against that background, we come to the theory of

24 harm. For this purpose it's going to be useful if you

25 have to hand the decision, and you may also want to have

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1 to hand the Office of Fair Trading's skeleton argument.

2 (Pause)

3 Before we look at the decision, firstly I ought to

4 explain, it is going to be necessary for us to follow

5 through with some care what is the theory of harm as

6 it's explained in the decision. So I apologise that we

7 will have to do that in a rather painstaking way.

8 The first thing to note is that it is common ground

9 that the trading arrangements here were novel and, to

10 use the words of Professor Shaffer, he describes them as

11 unusual and idiosyncratic, and they have not previously

12 been considered in the economics literature.

13 That of itself does not preclude necessarily the

14 finding of an object infringement. No-one is saying

15 that. But it does mean one's got to be particularly

16 careful where you have some new form of agreement which

17 you haven't seen before if you are going to classify

18 this saying it's necessarily anticompetitive. And that

19 explains, I would respectfully suggest, why the OFT

20 seeks to say that this is akin to a horizontal cartel,

21 because we all know that, and this is what they say --

22 a horizontal cartel is a bad thing, so it must follow

23 that if this is the same as, or akin to a horizontal

24 cartel, it must be a bad thing.

25 As I said, Mr Brealey is going to address you

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1 separately on the right legal approach, but can we just

2 see how the OFT has put the case.

3 In summary, you will see that the OFT is contending

4 that the RMS or the trading agreements were implemented

5 as imposing parity or fixed differential requirements so

6 that there was a requirement that the price of brand X

7 must be the same as the price of competing brand Y, or

8 a requirement that it must be Z pence less than the

9 price of competing brand Y.

10 If you take the decision, one needs to look quite

11 carefully at the way the matter is put, at page 10,

12 paragraph 1.4, and one tries to extract some of the key

13 things, you see that in 1.4 they say:

14 "The infringing agreements comprised in each case

15 an agreement or concerted practice between each

16 manufacturer and each retailer where the manufacturer

17 co-ordinated with the retailer the setting of the

18 retailer's retail prices for tobacco products in order

19 to achieve the parity and differential requirements

20 between competing tobacco brands in pursuit of the

21 manufacturer's retail pricing strategy."

22 The next sentence is particularly important:

23 "The infringing agreement between each manufacturer

24 and each retailer restricted the retailer's ability to

25 determine its retail prices for competing tobacco

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1 products."
 2 Now, immediately one has to think and ask: well, how
 3 did it effect such a restriction? What is the
 4 restriction that you are complaining about which you say
 5 is necessarily anticompetitive?
 6 If you then go on to 1.8, this is where they define
 7 what they say are the elements of the infringing
 8 agreements and the five elements, and you will see,
 9 looking at each one of those, that in a number of cases
 10 it's actually rather difficult to see what it is out of
 11 any of that which is alleged to give rise to any
 12 restriction.
 13 For instance, take the first one, the manufacturer's
 14 strategy in relation to retail prices. Well, the fact
 15 there is a strategy for Imperial to try and undercut
 16 Gallaher, so what? Then one has the written trading
 17 agreements, and the important thing is what's said about
 18 those, that it would price the brands, it would,
 19 according to the parity and differential requirements.
 20 So the language of obligation.
 21 Then you have contacts regarding retail prices of
 22 the manufacturers' brands, retail prices of the
 23 competitors' brands and retail prices of competitors.
 24 Payment and withdrawal of bonuses to incentivise the
 25 retailer to set its retail prices. Then frequent and

1 detailed monitoring.
 2 Now, if you then go to 1.10, the relevant provisions
 3 of some of the written trading agreements were phrased
 4 in terms of parity and fixed differential requirements,
 5 where others were phrased in terms of maximum
 6 differential requirements.
 7 In response to the statement of objection, some
 8 parties submitted that, irrespective of the language
 9 used, the parity and differential requirements merely
 10 imposed an obligation on the retailer not to set retail
 11 prices above a maximum price level, and that was not
 12 consistent with or did not lead to the manufacturer
 13 stipulating a fixed or minimum pricing obligation. Some
 14 parties submitted the notification of specified retail
 15 prices was merely a form of suggested or recommended
 16 retail prices."
 17 The next paragraph is important. They acknowledge
 18 that:
 19 "They were ostensibly expressed as maximum, and in
 20 certain communications instructions and/or requests were
 21 occasionally expressed as stipulating maximum prices or
 22 maximum differential. However, taking the evidence as
 23 a whole, they say the agreements in fact provided for
 24 parity and fixed differential requirements, implemented
 25 by communications from the manufacturer to the retailer

1 pursuant to which the retailer was to move to a specific
 2 price point."
 3 So there they seem to be saying, notwithstanding the
 4 terms of the agreement, which ostensibly are expressed
 5 in one way, the actual implementation is different, and
 6 ostensibly presumably is intended to be some sort of
 7 allegation that the agreements are a sham.
 8 If you go on to 1.12, then the restrictive nature of
 9 the infringing agreements resulted from the linking of
 10 the retail price of the competing brands since that
 11 restricted the retailer's ability to determine its
 12 retail prices for the manufacturers' brands and those of
 13 competing link brands to any extent that differed from
 14 the prescribed parity or differential.
 15 Stopping there for a moment, here they are
 16 introducing their case that there is a restriction on
 17 the retailer's ability to determine the retail prices.
 18 Now, if you then say, go on to the next paragraph,
 19 that is explaining that that was capable of restricting
 20 competition, that's their first sentence, and they
 21 explain:
 22 "Such a requirement precluded a retailer from
 23 favouring the brand of one manufacturer over those of
 24 another, and was capable of significantly reducing
 25 uncertainty both for a manufacturer which imposed the

1 P&D requirement and a competing manufacturer which
 2 observed the consequences of such requirement or had
 3 knowledge of such requirements as regards the retail
 4 prices of the manufacturers' brands and those of the
 5 competing brands. The long-term implementation of the
 6 P&D requirement would therefore reduce the incentives
 7 both for the manufacturer imposing the requirement and
 8 the competing manufacturer to engage in interbrand
 9 competition."
 10 We have then a detailed analysis of this at
 11 section 6, paragraph 214. It starts at page 129, which
 12 is headed "The restrictive nature of the infringing
 13 agreements". What they do is they have, at page 131,
 14 a section which is headed "The restrictive nature of
 15 a manufacturer's retail pricing strategy operating as
 16 a parity or fixed differential requirement", and at
 17 page 136, they have the restrictive nature where it's
 18 a maximum differential requirement.
 19 Their case is that, and it responds to a point that
 20 we were discussing this morning, it's not dependent upon
 21 the parallel and symmetrical allegation. So they start
 22 off by saying this is a bad thing and it's just a doubly
 23 bad thing if there was parallel and symmetrical.
 24 If you then go to 212, I won't read it all out, 212
 25 is explaining what they mean by a parity or fixed

1 differential requirement.
 2 Then 213 is important:
 3 "As stated in the SO, a parity or fixed differential
 4 requirement restricts a retailer's ability to determine
 5 the retail prices of competing linked prices because the
 6 relative prices of competing brands are fixed on the
 7 basis of the required parity or differential. If
 8 a parity or fixed differential requirement is
 9 implemented, an increase or reduction in the retail
 10 price of one brand leads to a corresponding increase or
 11 reduction in the retail price of the competing brand by
 12 an equivalent amount."

13 That is what lies at the heart of the complaint,
 14 that an increase or reduction in the retail price of one
 15 brand leads to a corresponding increase or reduction in
 16 the retail price of the other by an equivalent amount.

17 They then explain, in 214:
 18 "A parity or fixed differential requirement is
 19 capable of giving rise to significantly increased
 20 certainty for a manufacturer imposing a requirement,
 21 manufacturer A, that any change in the retail price of
 22 its brand, brand X, will be matched by a corresponding
 23 change in the retail price of the linked competing
 24 brand. In the absence of a requirement, manufacturer A
 25 can expect if it raises the wholesale price of brand X,

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1 the retail price of that brand will increase relative to
 2 the competing brand Y, assuming other factors remain
 3 constant. As a result, it will expect to suffer a loss
 4 of sales volume as consumers switch to the relatively
 5 cheaper competing brand.

6 "Conversely, manufacturer A would expect if it
 7 lowers the price of A, the retail price of that brand
 8 would decrease relative to that competing brand Y,
 9 assuming other factors remain constant and it will enjoy
 10 an increase in sales volume."

11 So this is where there is no P&D requirement that if
 12 you put your price up you expect to lose market share,
 13 and if you put your price down, you expect to increase
 14 to market share. Of course, this is all incredibly
 15 simplistic because it doesn't take account of the
 16 competitive responses in any event. Leaving that on one
 17 side, they are then contrasting the situation at 216
 18 where, if manufacturer A has a requirement that the
 19 retailer's price is linked to the retail price of
 20 competing brand Y, that requirement is capable of giving
 21 rise to a significant degree of certainty that the
 22 retail price of the two competing linked brands will
 23 move in parallel.

24 "Loss in the sales volume that manufacturer A would
 25 normally expect to suffer by increasing his price is as

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1 a result of an adverse shift in the retail price is
 2 therefore significantly reduced. As a result,
 3 manufacturer A would enjoy the gain in revenue from
 4 increasing its wholesale price without suffering the
 5 loss in sales volume", and so on.

6 Then in 217 they are looking at the situation of the
 7 manufacturer who doesn't have the P&D strategy but can
 8 observe it, and so they explain how that would work.
 9 Then at 218, they give an example where:

10 "Pursuant to an infringing agreement with ITL,
 11 a retailer was required to price Gallaher's brand,
 12 Dorchester, at parity with ITL brand, Richmond. That
 13 requirement would have significantly increased ITL's
 14 certainty that any change in the retail price of
 15 Richmond would be matched by a change in the equivalent
 16 direction and magnitude in the retail price of
 17 Dorchester, Gallaher's brand. Similarly, Gallaher would
 18 have been likely to observe over a time that on each
 19 occasion there was a decrease in the retail price of
 20 Dorchester, there was a corresponding decrease for both
 21 brands. On each occasion there was an increase in the
 22 retail price of Dorchester, there would be a matching
 23 increase in ITL's Richmond brand."

24 Then 219 is explaining how Manufacturer B's
 25 knowledge enables him to predict with certainty what's

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1 going to happen.

2 What is being contemplated here is, firstly, a fixed
 3 differential, they come on to say it doesn't make any
 4 difference whether it's maxima, but it's a fixed
 5 differential, and what they say is that this allowed
 6 achieving or maintenance of a degree of stability in
 7 relation to interbrand competition similar to that
 8 resulting from horizontal price co-ordination.

9 Now, this theory that we are looking at at the
 10 moment is what is described in the various reports as
 11 the lock-step mechanism, which is a requirement that the
 12 prices go up and down absolutely together. You will see
 13 that very clearly set out in the skeleton, if you go to
 14 the OFT's skeleton at paragraphs 11 and 12, where they
 15 explain what the fundamental proposition is in the case.

16 So you see at paragraph 11:

17 "Fundamentally the P&D requirements constituted
 18 agreements between manufacturers and retailers which
 19 required [note that word] a horizontal link between two
 20 rivals' retail prices. The appellants seek to obscure
 21 this basic nature of the requirements by, for example,
 22 discussing differently formulated P&D requirements
 23 seeking to emphasise the vertical aspect to the
 24 agreements or preferring various explanations for the
 25 existence of the requirements. However, not even the

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1 appellants would surely dispute the fact that
2 an agreement between two manufacturers always to price
3 their rival products at identical levels to each other
4 is presumed to be anticompetitive."

5 So you have a situation where the manufacturers are
6 always pricing at identical levels. Then they say:
7 "There is no reason in logic or principle or even
8 persuasively proffered by the appellants, who failed to
9 grapple with the fundamental problem with the infringing
10 agreements, why the position should be any different
11 when manufacturers use retailers [so that is what is
12 being alleged, the manufacturers are using the
13 retailers] to provide the same horizontal link."

14 Stop for a moment. The same. So what is being said
15 here, if "same" is a reference back to an agreement
16 between two manufacturers always to price their rival
17 products at identical levels or at identical
18 differentials. Then they say:

19 "Underneath all of the economic analysis and
20 detailed descriptions of the theory of harm is the
21 rather obvious proposition that if one manufacturer
22 knows [so you have knowledge here] its rival
23 manufacturer's retail price will always [note the word
24 'always'] be the same relative to its own retail price,
25 then it can never [again an important word] win or lose

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1 customers from or to its rival. If it can never win
2 customers, there is no point lowering the price of its
3 product as it will not profit. However, both it and its
4 rivals can profit from raising their prices given they
5 will not lose customers.

6 "The conclusion is both logical and simple. Prices
7 will increase and this will lead to greater profits for
8 everyone, manufacturers and retailers alike, which can
9 be divided between them."

10 So what explicitly is being said here is that what
11 is going on here is a cartel of some sort or
12 an arrangement whereby each manufacturer knows that its
13 rival's product, whatever it does, will always be the
14 same relative to its own, therefore there is no point in
15 cutting prices and only point in putting up prices.

16 Now, it is said that the RMs gave rise to the same
17 horizontal link as the cartel between the manufacturers,
18 it provides the Tribunal with a very useful benchmark by
19 which to assess whether the evidence bears out any of
20 this.

21 For example, it means that the economic data
22 regarding what actually happened during the alleged
23 infringement period to shelf prices, the market shares
24 of Imperial, Gallaher and their margins, one would
25 expect all that would be the same as if there had indeed

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1 been such a horizontal cartel. Of course, you won't be
2 surprised to know that actually the evidence is to the
3 opposite effect.

4 A more simple point, we have already looked at two
5 of the trading agreements, does one see in those trading
6 agreements this type of arrangement whereby always the
7 prices are to be the same, relatively? How does one fit
8 into this analysis at paragraph 12 the opportunity to
9 respond? How does one fit into this the provision
10 I showed you in the Morrisons and Sainsbury's agreement,
11 which is actually providing that prices should not be
12 put up other than when there is an MPI or Budget
13 increase?

14 Now, both what's said in the decision and what one
15 sees here, provokes one to ask -- and that's why it is
16 important to see whether the agreements or the
17 arrangements, however one wants to put it, did they in
18 fact impose requirements at all? If they didn't impose
19 requirements at all, they were merely incentives, it's
20 very difficult to really see how you get this
21 restriction, bearing in mind the very low level of the
22 incentives; and secondly, in any event, whatever you say
23 the agreements were providing, were they providing that
24 retail prices of rival products must always be
25 relatively the same?

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1 Now, central to the OFT's theory of harm is the
2 notion that the retailers were precluded from favouring
3 Gallaher's brands over those of Imperial. That you have
4 seen already, I think, at paragraph 1.13, which we have
5 looked at. Then also the same point is made at 6.7, and
6 6.206.

7 Professor Shaffer explains this, perhaps it's worth
8 looking at his 2010 report, so that one can see the
9 basis on which he was proceeding, in volume 6 of the
10 core bundle.

11 **DR SCOTT:** Just while you pause, we probably need to read
12 into the word "identical" the footnote which is
13 identical plus or minus a small differential.

14 **MR HOWARD:** I am sorry?

15 **DR SCOTT:** There is a footnote, if you look back at the
16 skeleton argument, they qualify "identical".

17 **MR HOWARD:** You are right, but it's not in any sense in
18 relation to what we are discussing a material
19 qualification. In other words, they are using
20 "identical", it covers a situation including where there
21 is a differential. That I agree, I had understood that.
22 But the important thing is that that differential is
23 fixed for all time, or for the duration of the
24 agreement, whatever happens, so that their case is
25 Gallaher can't put its price down, and you, Imperial,

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1 can put up -- Gallaher can put up its price knowing it
 2 can bring you up, Imperial, at least so that it doesn't
 3 suffer too much -- well, it doesn't suffer any
 4 disadvantage from its current position, and you,
 5 Imperial, can do the same.
 6 But it is absolutely clear on this part of the case,
 7 in paragraphs 11 and 12, the fundamental proposition.
 8 The reason I really want to emphasise that, you are
 9 going to see that, although this is the fundamental
 10 proposition, because they realise that this is factually
 11 nonsensical, we then get what is a different case, which
 12 is not specifically addressed but what they are saying
 13 is: oh, well, it somehow has an adverse effect on
 14 competition that Imperial might be able to reduce its
 15 prices more effectively in competition with Gallaher,
 16 and that that which is pro-competitive, one might think,
 17 that somehow leads to an anticompetitive effect.
 18 But that is not part of the fundamental proposition
 19 it's actually part of a case which one can pejoratively
 20 say is all done by smoke and mirrors or sleight of hand,
 21 but they set up this case which one can understand what
 22 it is being said, and then they look at something
 23 which is quite different and say, oh, well, that's
 24 nevertheless still the same and covered by our theory of
 25 harm. It isn't. It's, as you will see, quite

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1 different.
 2 Now, I was taking you to Professor Shaffer, and to
 3 his 2010 report, which is at tab 65. Paragraph 17, this
 4 is part of his summary of his conclusions, and he is
 5 explaining his conclusion, which is as to why a P&D is
 6 expected to have anticompetitive effect. At 17 he
 7 explains:
 8 "The manufacturer's trading arrangements would be
 9 expected to introduce interbrand competition from the
 10 moment they are established ..."
 11 Stopping there for a moment, if Professor Shaffer's
 12 point is right in relation to the facts, he is saying
 13 from the very moment these agreements are established
 14 there is an anticompetitive effect. Well, one really
 15 would say it's pretty surprising if Professor Shaffer is
 16 right that none of this can be demonstrated in practice.
 17 One would have thought there is something wrong with the
 18 theory, or that the facts are different.
 19 Then one sees:
 20 "... because each manufacturer's trading
 21 arrangement would reduce the incentive of the rival
 22 manufacturer to compete and increase the incentive of
 23 the manufacturer with whom the retailer has the
 24 arrangement to raise its wholesale price.
 25 "In the former case, incentives to lower wholesale

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1 prices would be reduced because the rival would be
 2 unable to shift relative retail prices in its favour."
 3 That's the important thing. What he is saying is
 4 it's not possible for, where these P&Ds are there,
 5 Gallaher to shift relative retail prices in their
 6 favour, to which the obvious riposte is certainly (a)
 7 they were trying to do it and (b) there was nothing in
 8 the agreements to stop them, they would reduce their
 9 price, the only thing that might upset the apple cart
 10 from Gallaher's point of view is not that the retailer
 11 did anything independent of Imperial, but that Imperial
 12 then implemented its own price reduction.
 13 Well, that has nothing to do with an inability to
 14 shift relative retail prices; it's to do with
 15 competition operating in favour of the consumer but
 16 possibly against Gallaher.

17 **THE CHAIRMAN:** He discusses it entirely in terms of response
 18 to changes in manufacturers' wholesale prices.

19 **MR HOWARD:** And so does the OFT.

20 **THE CHAIRMAN:** Well, in the first place where you showed us
 21 in the decision, they seemed to regard the stability of
 22 prices at the retail level as one point and then the
 23 effect of that on wholesale prices and incentives. But
 24 I don't know whether it ever was part of their case
 25 that, even if you ignore sort of shock events, if I can

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1 call it that like, of MPis and just look at prices of
 2 linked brands, during a period where there is no MPI or
 3 no promotional thing, whether because of the agreements
 4 those remain more static than they would do in the
 5 absence of PDRs because the retailers don't of their own
 6 initiative move the prices about as they might do with
 7 other kinds of products in a way that's going to disrupt
 8 the differential, absent any change in the wholesale
 9 price.

10 **MR HOWARD:** That is not an articulated case. There are
 11 a number of reasons, one suspects, why it isn't. There
 12 is a hint in paragraph 41, I think, of the skeleton of
 13 such a case, but that's not the case in the decision.
 14 The thing is, everything in the decision, if one looks
 15 at the section on the restrictive nature of the
 16 agreements, it is all linked to the effect on the
 17 manufacturers, not the effect on the retailer.

18 Now, one of the reasons for that is that, firstly
 19 you have to remember we are in an object case, we are
 20 not looking at what is the actual effect, that's because
 21 the OFT did an effects analysis, couldn't find anything,
 22 but they are not saying, well, it did in fact have
 23 an effect. You are then having to say, well, we have to
 24 actually think about how this operates. What Imperial
 25 is seeking to do is to lower the price of its brand. If

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1 you were to say that, well, you have then incentivised
2 the retailer to price your product below that of
3 Gallaher, if you say, well, if he accepts your
4 incentive, then by doing that, at least in order to
5 maintain the bonus, he cannot reduce the price of
6 Gallaher.

7 The question is, if you say, well, you have then to
8 contemplate: would he have wanted to reduce the price of
9 Gallaher below Imperial for some reason? This is
10 a market where we already know that that is not what the
11 retailers do, they are not actually interested in
12 independent pricing initiatives, except insofar as they
13 benchmark themselves against their competitors, in which
14 case they do it anyway, so they will move the prices
15 around if they feel they have to do that, because that's
16 a more important consideration. But secondly, even if
17 you contemplate a situation where the retailer might
18 independently want to reduce the price of Gallaher, the
19 question is: well, can you say that that necessarily --
20 let's say you say they are precluded from that, that
21 that necessarily is going to have an anticompetitive
22 effect, because what one is then contemplating is that
23 the price of Imperial will be higher. In other words,
24 it becomes a rather complicated inquiry to find out
25 whether the position is overall that prices would be

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1 higher or lower, if you assume that the retailers in the
2 first place had any interest in entering into that sort
3 of price initiative off their own back in the first
4 place.

5 The thing is, that's not the basis on which the OFT
6 has proceeded and the basis on which we are dealing with
7 their theory of harm. That's the difficulty with then
8 postulating something quite different.

9 **DR SCOTT:** Sorry, a moment or two ago you said that
10 Imperial's concern was to reduce their price. My
11 recollection of, I think it's Mr Good, is that his
12 concern was with the differential. Clearly there
13 couldn't be a long-term desire to go on reducing the
14 price, because Imperial's own margin would disappear,
15 and as we have already discussed, from the point of view
16 of the relationship between the overall elasticity and
17 the cross-elasticity, Imperial's prime concern is with
18 the differential rather than with absolute price
19 lowering. Because that is what's the key to market
20 share.

21 **MR HOWARD:** With respect, it is two things and you see that
22 pretty clearly in the Sainsbury's agreement, where they
23 are actually concerned with the absolute --

24 **DR SCOTT:** Yes, there is an absolute, yes.

25 **MR HOWARD:** Of course there would be reductio ad absurdum to

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1 say that they just want to keep pushing down prices.
2 Obviously what they want is to be competitive with
3 Gallaher but also to ensure that the retailer is not
4 charging an undue margin on their product and so they,
5 having set what they regard as a lower wholesale price,
6 that that is feeding through into the retail price.

7 It's not quite as simple as saying it's just about
8 relativity, but in a market where you have two major
9 players, being cheaper than the opposition is obviously
10 taking you a very long way in being attractive to the
11 consumer.

12 But the discussion, the launch pad for all of this
13 is: what is the case on the theory of harm? And that
14 is, I would suggest, very clearly set out in this
15 decision which is it is the effect on the respective
16 manufacturers' behaviour, ie it disincentivises the
17 manufacturer from reducing the wholesale price, and in
18 fact gives you an incentive to increase prices, that
19 that then feeds through to the retailer. There is not
20 a theory of harm which has been articulated or supported
21 by an expert that somehow we are just looking at things
22 divorced from whatever the manufacturers do, and we are
23 concerned with things at the retail level. If that were
24 the case that were being advanced, we would have had to
25 consider that, and we would have had to call appropriate

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1 expert evidence. I say that not because it is important
2 because of the reference in the Office of Fair Trading's
3 skeleton at paragraph 41. That is where they make this
4 point:

5 " ...the retailers may want to change the
6 relativities of prices entirely independent of any
7 Manufacturer price changes. The four permutations [that
8 we put forward] do not reflect all constraints ..."

9 But the answer is those are the only constraints
10 that you, OFT, have put forward as being relevant in the
11 decision, and it's the decision that we have to address.

12 **THE CHAIRMAN:** Because the theory of harm is based on
13 competition at the wholesale level and not at the retail
14 level.

15 **MR HOWARD:** Exactly. That's the whole thing. And that's
16 why, I mean, the whole of the Shaffer analysis is at all
17 about -- if one looks at it in very simple terms and we
18 stand back for a moment, and I know that obviously you
19 have all read with care the reports, but what you will
20 find is you have a simplistic model which is assuming
21 lock-step. Professor Shaffer says "I haven't done any
22 investigation, that's what I assume", and you find that
23 very clearly articulated in his 2007 report.

24 Then in the decision and in his 2010 report you will
25 see some reference to opportunity to respond, and I'll

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1 come on to that. That's said to just be uncertain
 2 compliance with a lock-step obligation, so in other
 3 words there is still a lock-step obligation but just you
 4 don't, it's not 100 per cent certain it's complied with,
 5 to a new case via his response to the experts' joint
 6 statements and his 2011 report, which seems to just be
 7 saying: well, there is some general expectation that
 8 Imperial can undercut and that will have an adverse
 9 effect.
 10 But it's important to see that the case has always
 11 been about this lock-step. I showed you paragraph 17 of
 12 his 2010 report. If you look at that same report at
 13 paragraph 120, you will also see the position set out
 14 very clearly, where he talks about -- no, sorry. It's
 15 where he uses the lock-step. It may be that that's the
 16 first time he uses "lock-step". That you see at 120,
 17 that's the third line, his reference to "lock-step".
 18 Now, the lock-step mechanism which Professor Shaffer
 19 is putting forward and is at the heart of the OFT's
 20 theory of harm is one where you have got the -- what one
 21 is looking for is the constraint upon the retailers
 22 which they say then causes a response by the
 23 manufacturers, which essentially is to disincentivise
 24 them.
 25 So you have the situation where Gallaher implement

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1 a wholesale price increase; what, on this theory of the
 2 case, is required is that whenever they put up the
 3 price, then the retailer has to increase the
 4 corresponding Imperial brand by the same amount.
 5 Similarly, if there is an Imperial wholesale price
 6 increase, then similarly Gallaher has to go up; when
 7 there is an Imperial price decrease, Gallaher has to
 8 come down; if there is a Gallaher reduction, Imperial
 9 has to come down.
 10 The other point to note on the retailers' position,
 11 just to pick up that point: of course the retailers,
 12 their main objective -- at least for the supermarket
 13 chains, who are amongst the major parties here -- is to
 14 benchmark their competitors, and they have no interest
 15 in funding individual price cuts. But equally, it makes
 16 no sense to think that they were undertaking not to
 17 react to, in their own interests, what their competitors
 18 were doing and, again, there is absolutely nothing in
 19 the agreements which will support that.
 20 Now, it is necessary to nail this point that they
 21 are talking about a lock-step and, if there was any
 22 doubt about it, you can pick it up in the OFT's defence,
 23 which is in core 4, where they criticise us for
 24 misunderstanding their case.
 25 {C4, tab 46, page 227}, you will see at the foot of

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1 page 227 they refer to the notice of appeal and then
 2 say:
 3 "ITL argues that if Gallaher reduced its prices,
 4 a retailer was free to reduce the [there they must mean
 5 its wholesale prices] a retailer was free to reduce
 6 [there they must mean the retail price of] the Gallaher
 7 brand without loss of ITL's incentive payment. That
 8 point, which is derived from a mistake made by ITL in
 9 [a particular paragraph of] the notice of appeal and
 10 repeated, concerning decision 1.13, is addressed at [the
 11 various paragraphs]."
 12 You will remember paragraph 1.13 of the decision,
 13 which we looked at a little while ago, was the paragraph
 14 explaining the restriction on the retailers. So in
 15 footnote 45 they explain the position. They say:
 16 "Paragraph 1.13 states that such a requirement, that
 17 is the restriction on a retailer's ability to determine
 18 its retail prices for competing linked brands, precluded
 19 a retailer from favouring the brand of one manufacturer
 20 over those of another. That was repeated in
 21 paragraph 6.7 of the decision."
 22 Then they helpfully give us an example:
 23 "An example of the situation is this: if
 24 manufacturer A requires the retailer to price A's brand,
 25 X, at 3p above manufacturer B's brand Y, that fixes A's

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1 preferred price relationship between X and Y. The
 2 retailer is precluded from favouring Y over X because,
 3 even if the price of Y is reduced, the retailer is bound
 4 to change the price of X accordingly in order to
 5 maintain the price relationship between those brands
 6 determined by A. ITL misses the point entirely."
 7 Well, we don't miss the point. We understand. We
 8 didn't before, we certainly understand here. It's made
 9 crystal clear what the case is. It is, the retailer
 10 being precluded, he's bound to change the prices.
 11 The same point is in fact made in the skeleton at
 12 paragraph 12, and I've already shown you that.
 13 Professor Shaffer's 2007 report also makes the point
 14 very clearly, that's at tab 64. Actually we looked at
 15 paragraph 17 already. Sorry, the 2007 report, I beg
 16 your pardon. If you go back to the 2007 report.
 17 **THE CHAIRMAN:** At tab 64 of bundle 6?
 18 **MR HOWARD:** It's tab 64, I beg your pardon, and it's
 19 paragraphs 16 and 17 there:
 20 "In the absence of parity and differential
 21 requirements the retailer is able to raise the price of
 22 the manufacturer's product without having to change the
 23 price of competing products. Typically one would expect
 24 the retailer to increase the retail price of the
 25 manufacturer's product in response to a wholesale price

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1 increase. Since the wholesale price increase increases
 2 the retailer's marginal cost, since the higher retail
 3 price affects consumer demands, not only for the
 4 manufacturer's own product but also for all competing
 5 products, the retailer would typically also want to
 6 change the prices of the competing manufacturer's
 7 products. Whether he will want to increase or decrease
 8 these prices depends on the trade-off between two
 9 opposing considerations", and he explains what those
 10 are.

11 In 17 he explains:
 12 "In the presence of P&D requirements, the retailer
 13 is not able to raise the price of the manufacturer's
 14 product independently of the price or prices of the
 15 competing products. In this case, if the retailer
 16 raises the price, it must also raise the price of the
 17 competing products."

18 **THE CHAIRMAN:** It doesn't mention, in the second half of
 19 paragraph 16 there, the point that you made, which is
 20 that he may not want to raise the price of the other
 21 products in relation to which there has been no increase
 22 in the marginal cost if he thinks that his competitors
 23 at the retail level are not going to raise those prices.

24 I think you would say that that's an additional
 25 factor which the retailer would generally take into

1 account when considering how to change prices, retail
 2 price of competing products.
 3 **MR HOWARD:** What he is saying is that where the Imperial
 4 price goes up, without a P&D requirement, as
 5 I understand it, he is saying the retailer may --
 6 I mean, he is actually saying that he may or he may not
 7 want to put up the price of the Gallaher product. The
 8 reason he may want to do it is, under cover of
 9 Imperial's price increase, he may use it as
 10 an opportunity to increase his margins on Imperial's
 11 product, but he may have competing considerations which
 12 mean he doesn't want to do that.

13 He starts off by saying the retailer typically wants
 14 to change the price of the competing manufacturer's
 15 products, but whether he wants to increase or decrease
 16 the price depends upon the trade-off between the two
 17 considerations. One:

18 "... and demand for those products is higher, which
 19 suggests he may want to take advantage of this by
 20 raising his other prices. On the other hand, the profit
 21 margin on the manufacturer's product is now lower, which
 22 suggests he may want to lower slightly the price of the
 23 substitute product to induce even more consumers to
 24 switch. In general, either effect may dominant the
 25 retailer and it's an empirical issue whether he will

1 want to raise or lower the prices of the competing
 2 products in response to a wholesale price."
 3 In fact you are probably right, he is not quite
 4 reflecting the point that I made, but the bottom line is
 5 he is saying that if one manufacturer puts up his price,
 6 then the retailer may or may not want to put up the
 7 price of the other product, and he is contrasting that
 8 with his assumption of the P&Ds that the retailer has no
 9 choice, he is not able to raise the price of one
 10 independently. Not able. He must also raise the price
 11 of the competing product.

12 **THE CHAIRMAN:** Yes.

13 **MR HOWARD:** That's the critical point that comes out of
 14 this.

15 **THE CHAIRMAN:** Yes. You say that's the assumption that
 16 underlies his analysis.

17 **MR HOWARD:** It is, yes. It's inescapably so. You will see
 18 that, notwithstanding that, he tries to escape, but that
 19 is indeed the analysis.

20 **THE CHAIRMAN:** Is that a good point to break?

21 **MR HOWARD:** It is.

22 **THE CHAIRMAN:** Thank you very much. Thank you, everyone.
 23 I think there is now a glossary that will be circulated
 24 by email, and we will meet again at 10 o'clock tomorrow
 25 morning. Thank you.

1 (4.30 pm)
 2 (The court adjourned until 10.00 am on
 3 Thursday, 22 September 2011)
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