IN THE COMPETITION APPEAL TRIBUNAL

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

Victoria House,
Bloomsbury Place,
London WC1A 2EB

21 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.

Wednesday, 21 September 2011

(10.00 am)

THE CHAIRMAN: I have a few preliminary remarks, Mr Howard, thank you.

Good morning, ladies and gentlemen. First of all, many thanks to everybody for the very helpful submissions that we received at the start of the summer from you all, and also many thanks to those who have set up the courtroom this morning. We have read much of the material in the core bundles over the summer, and so we are reasonably familiar with the issues and the factual background.

Just a few housekeeping matters to deal with before we start. As regards the factual witnesses whose evidence we will start hearing on the 30th, you can assume that we will re-read the witness statements and any contemporaneous documents that are expressly covered by the witness in his or her statements, but it would be useful if you would let us know at the end of the previous day's proceedings if there are any particular paragraphs of the decision or other documents in the annexes that it would be helpful for us to read before the witness starts.

Secondly, we are producing a glossary based on the one at the back of Imperial's notice of appeal. We will

circulate a copy of where we have got to with that at the end of today's hearing, and it would be useful for someone to keep a running version of this by adding new terms to it as and when they arise, and that can be recirculated electronically as and when appropriate.

On similar lines, I understand that Imperial has agreed to create a bundle of any documents that are handed up during the course of the hearing and provide an index for that.

As regards documents which emanate from or involve the parties and contain their confidential information, we hope that all parties will be alert when they are preparing their cross-examination as to whether they need to seek the permission of the owner of any information before using the document in court, so that we don't have any delays to witnesses caused by that.

On the matter of confidentiality, there has been an exchange of correspondence about setting up remote access to the transcript, and this morning I signed an order dealing with arrangements for those already in the confidentiality ring to have access to that.

A related issue is one that arose in the Pay-TV case, namely whether people who are not in the confidentiality ring but who belong to the party which is the owner of the confidential information should be

able to remain in court when that matter is being discussed. The advantage is clearly that the person can then give instructions, if needed; the disadvantage is that there is then a multiplication of editions of the day's transcript that need to be produced at the end of the day.

If the parties are prepared to take responsibility for sorting that out, and making sure that confidential information isn't inadvertently disclosed, then we are happy to proceed on the basis that the person can remain in court, but perhaps you can give some thought to that.

Of course we would appreciate having as much notice as possible of when the Tribunal is going to be asked to sit in camera, if that arises, and we assume that parties will group their cross-examination questions to minimise the number of times we have to clear the court.

Finally, on the issue of confidentiality, can we please charge junior counsel in each team with making sure that they know who is sitting in their section and whether or not they are in the ring, and for ensuring that when we do sit in camera, only those who are within the ring remain.

Turning to the experts' evidence, it would be fair to say that we have all read the primary reports of the experts dealing with the theory of harm. We are less

familiar with the matters surrounding the earlier report of Professor Shaffer and with the material in the statement of Mr Walker and those who cover that aspect of the case.

So with those preliminary matters out of the way, we are now ready to start. Mr Howard, I think we will take a ten-minute break part way through the morning at a time that is convenient to you.

Opening submissions by MR HOWARD

MR HOWARD: Of course. I will refrain from introducing everybody since I am sure you know who the parties represent.

The UK tobacco market is highly taxed and highly regulated. The effect of that is, firstly, that tax forms a very significant part of the retail price of tobacco. For instance, in the time under question, in this case 2000 to 2003, when a packet of cigarettes cost approximately £4, some 80 per cent or so, £3.60 approximately, went to the Treasury.

Secondly, regulation increasingly prohibited advertising, resulting in a so-called "dark market". So manufacturers such as Imperial had very little opportunity to promote their products other than on price. Although price is therefore the principal means of competition, there are a number of difficulties that lay in the way of price competition. The first is that Imperial can reduce the price of its products, that's the wholesale price, and it did so, but it had no assurance that the retailers would pass on the reduction in the wholesale price to the consumers.

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

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

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

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

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

Now, retailers are of course not obliged to follow the RRPs and the extent to which they generally seek to price above or below the recommended retail price depends upon their particular pricing strategy, both nationally and locally.

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

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

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

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

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

a subjective or objective basis.

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

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

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

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

Instead, it puts its case solely on the basis of a unique object theory of harm. As is clear from paragraphs 11 to 12 of the OFT's skeleton, to which I'll return later, what the OFT is essentially alleging -- and it doesn't shrink from this -- is that the differential provisions were akin to horizontal co-ordination between Imperial and Gallaher.

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

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

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

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

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

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

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

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

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

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

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

Recognising that the very existence of the

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

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

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

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

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

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

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

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

Secondly, Imperial's desire to undercut Gallaher,

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

DR SCOTT: One other question related to the RRPs: earlier on I think I heard you saying that the differentials in the trading agreements were sometimes but not always reflective of the RRPs.

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

DR SCOTT: Thank you.

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

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

The importance of course of tobacco products to most of the retailers is that it's not a product that they promote, they can't in fact advertise, but it is important as a means of attracting customer footfall into their stores and so as a means of selling other products.

The conflict in the incentives is explained by Mr Ridyard in his first report in core volume 3 at tab 25. {C3 tab 25}

Paragraph 43 explains:

"Hence, whilst both manufacturers and retailers can be expected to take an interest in tobacco pricing and be responsive to price changes, the precise focus of this interest differs between the two groups. Each manufacturer will have a clear interest in low retail prices for its brand as a way to increase sales, with particular interest in how its brands are priced relative to those of rival brands in the store. Each retailer, in contrast, is likely to be less concerned with the relative price of one brand against another, and more concerned with the way in which consumers perceive its general price competitiveness on the sale of tobacco products relative to retailers in its immediate competitive set. As we discussed below, this difference in perception affects the way in which manufacturers such as ITL sought to incentivise retailers in the context of its trading agreements."

We don't need to turn it up, but a similar point is

made in Professor Froeb's first report at paragraph 11, and the point is in fact echoed in Professor Shaffer's 2010 report, which you will find in {core 6, tab 65 at page 44}, and again I don't think we need to take time up referring to that at the moment.

Now, this problem was compounded by the next two particular features of the market. The first is the dark market, which, as we all know, the Government gradually, and perhaps with ever increasing rapidity, introduced various advertising restrictions over the last few decades.

Since the Tobacco Advertising and Promotion Act of 2002, there is a complete ban on billboard and press advertising. All that tobacco manufacturers are allowed to do is to place a single advert not exceeding A5 size at the point of sale. Thus, traditionally, tobacco manufacturers used to spend very large amounts of money promoting the visibility, image and brand values of their products, sponsoring sporting events and other such things. Now effectively that is all finished and we have the dark market.

The restrictions on advertising are recognised by the OFT in the decision at paragraph 5.12 and explained by Mr Batty in his statement and Mr Cheyne. Mr Batty you will find in {C3, tab 33 at paragraphs 2.6 to 2.11},

and Mr Cheyne in {C3 tab 34 at paragraph 32}.

Now, the absence of any advertising has the result that competition on price is particularly important, and again this is common ground, see the decision at paragraphs 6.256 and 8.64.

Because price competition has become such a key feature of the market, and no doubt also because of the increased tax levy, making consumers more price conscious, there has been a development in growth of what's called the low price and the ultra low priced product categories. Again, they are explained by Mr Batty in his statement at 2.8 to 2.9.

Mr Cheyne, it's perhaps worth turning up his statement at this point in core 3, where he explains the importance of the price competition. Mr Cheyne is a former consultant to both First Quench and Somerfield. His statement is to be found in {C3 at tab 34 at page 387}.

Perhaps if you just glance at paragraph 32, he explains the emergence of the dark market, and then in paragraph 33, he explains that:

"The manufacturers' strategies focused on making sure that their products were widely available in the market and were priced competitively. In order to achieve this, they sought to ensure that the retailers

stocked a wide range of product lines and that retailers' merchandising and displays were effective (which meant, for example, that each manufacturer preferred to have its own gantries in retail chains). In my view, the importance to the tobacco manufacturers of product availability and competitive pricing was based on a continuing concern that customers would ultimately switch to a competing brand if their usual or preferred brand was not available on the shelves or it was perceived as being poor value compared with a rival brand. In my experience, although many smokers remain loyal to their particular brands, the ever increasing levels of tax have meant that more and more consumers are willing to switch to better value brands, particularly in the lower price sectors, for example, Dorchester (a Gallaher brand) and Richmond (an ITL brand).

"34. The perceived threat of switching, coupled with UL's aggressive growth strategy meant that competition between ITL and Gallaher was particularly vigorous, both in terms of the product service/mix offering and pricing."

Now, the competition on price is particularly important given that those who smoke, and therefore purchase cigarettes, are spending a significant part of their disposable income on cigarettes, or at least that would be the case for many people.

So in order for Imperial to win market share from Gallaher, it was incumbent on it to devise a system of making its retail products more attractively priced in the stores relative to the price of Gallaher's products.

The next point that's important in relation to all of this is that price competition in this market, at the consumer level, has to be driven by the manufacturers, because it is a feature of the market that firstly retailers are very unlikely to pass on wholesale price discounts to consumers themselves, and they are very unlikely independently to implement price reductions of their own initiative.

This all comes out of the fact that there is a very high tax regime, tax could constitute 80 per cent or more of the retail price. As a result, tobacco products represent low margin products for the retailers. There are various estimates of what it is. Mr Batty, at {paragraph 2.23 of his statement in C3/33} estimates that the gross retail margin on factory made cigarettes products is as little as 5 per cent. Mr Cheyne estimates that on average for a retailer the margin is around 7 to 9 per cent on tobacco products, as to be contrasted with 25 to 45 per cent on other grocery

products. Mr Cheyne is in {core 3, tab 34, page 382}.

The effect of the low margins means that the retailers have little incentive to pass through wholesale price discounts which are being provided by the manufacturers. This is explained by Mr Ridyard at {C3, tab 25, page 93}.

This is in a section of his reporting explaining that the essential motivation for the RMSs is pro-competitive. At {C3, tab 25, 234} he explains that:

"In a setting where retailers' margins make up a very small element of the typical retail price (under 10 per cent) both economic theory and observed market conduct predicts that retailers have muted incentives to pass through manufacturer wholesale price cuts or unconditional bonus payments in the form of lower prices. As discussed in Section 2 of this report, this arises from the fact that even a large cut in retailer remuneration will affect retail prices (and hence consumer demand) only marginally. Hence, the ability of manufacturers to make the payment of bonuses contingent on the retailer's performance of certain output -expanding activities is useful for the manufacturer."

You can read to the end of that.

Because of the low margins, the retailers themselves have very limited scope to implement profitable own

account price reductions of their own initiative. Again, that is explained by Mr Cheyne at paragraphs 18 to 19, but the best illustration of it is back in Mr Ridyard, if we could turn back, if you still have it open, at pages 19 to 20, where he graphically explains the position at paragraph 31:

"As the Decision notes, tax can constitute 80 per cent or more of the retail price of a tobacco product. This means that manufacturer and retailer margins form a small proportion of consumer prices. Moreover, because the specific duty is fixed irrespective of the price of the product, and the ad valorem element is determined by the products RRP rather than actual selling price, neither the manufacturer nor retailer has the ability to exert a strong influence over consumer prices. For example, a supermarket in 2003 typically would have sold Lambert & Butler ("L &B ") KS 20s for £3.98, of which the tax element would have been in the region of £3.52 (88.5 %). Therefore, to achieve a 5% reduction in the consumer price , the price per pack excluding tax would need to fall from £0.46 to £0.26, which represents a reduction of 43% in the price excluding tax, assuming that the tax payable on the product would remain largely or completely unchanged. Since the supermarket retailer's gross margin on this product might typically

have been around 5% or less of the retail price, it is easy to see that retailers in particular (since they exert no control over RRP) have very limited scope to initiate profitable own account price reductions."

MR SUMMERS: Mr Howard, I wonder if I could ask for a little clarification. We are hearing a lot about low margins in the industry, it's very evident in the papers throughout, but we also know that there are off-invoice payments, there are bonuses, things described as central support. When we talk about low margins, or when these papers talk about low margins, are they talking about the margin before the application of these other forms of support to the price which is then offered?

MR HOWARD: They are generally talking about the position after taking account of everything.

MR SUMMERS: Everything?

MR HOWARD: That's right. One of the things you have to bear in mind is the levels of support, particularly in relation to the RMS bonuses is very small indeed. What one is looking at generally is the overall position.

MR SUMMERS: Because I am not an accountant, but I do understand that there are accounting issues relating to central support, and that in some companies that may be treated, as it were, as something that goes straight to the bottom line and in other cases it is applied directly back, as it were, to the product.

MR HOWARD: I'll check precisely what the position is, but my understanding is that all or certainly most of what is being paid by way of support is basically margin support on the whole, and therefore it is, when one is determining what the margin of the retailer is, we have to look at the wholesale price plus any additional support that is obtained.

MR SUMMERS: Thank you.

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

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

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

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

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

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

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

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

Now, the transparency of pricing which results from

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

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

THE CHAIRMAN: The RMSs?

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

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

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

"As regards the high tax burden on tobacco products, paras 31 -32 of DR1 explained how the tax arithmetic dulls the retailer's incentive to pass on a wholesale price reduction. That in turn again explains why retailers may be inherently unmotivated to initiate retail price competition in these products and provides useful context to explain why ITL sought to use RMSs (alongside other measures and incentives) to encourage retailers to cut retail prices when wholesale prices fell. In DR1 I mentioned a number of other factors concerning the regulation and public perception of tobacco products that could also explain why it would be additionally difficult to persuade retailers to participate in manufacturer initiatives to boost sales volumes of their brands.

"The role of RRPs. Mr Walker refers to the comments in DR1 regarding the role of RRPs, and he contends that I did not explain why the transparency that arises from RRPs was relevant to the competitive assessment I appreciate that suppliers in a number of consumer goods markets publish RRPs, but the de facto legal requirement for tobacco manufacturers to do so does in my view make

this industry distinctive, if not unique. This degree of transparency on manufacturer pricing is relevant to the competitive assessment because the inter-brand price transparency that arises through the requirement to publish RRPs, in conjunction with the frequent common cost shocks caused by taxation increases, provides a ready explanation for the degree of parallel pricing one observes in the industry that exists independently of the presence of RMSs. Specifically, in order to conclude that RMSs had the effect alleged by the OFT of securing increased parallel movement in inter-brand prices, it is important to distinguish this alleged effect clearly from the tendency for highly transparent RRP announcements to have a similar influence on price progression over time. Such considerations become acutely important when considering the so-called dynamic theories of coordinated pricing that are discussed in Section VI of GS.

"For example, at paragraph 194 GS speculates on the possibility that manufacturers 'might' over time anticipate rivals' responses, and at paragraph 195, he further speculates that observation of rival suppliers' behaviour 'might' allow them to coordinate their wholesale pricing decisions. These are of course standard concerns in any theory of price coordination in

a concentrated market with high transparency, but speculation as to whether such conduct might over time lead to price coordination is not the same as a conclusion that it is likely to do so. Experience with evaluating coordinated effects concerns in competition law investigations shows that this task requires a very fact-intensive inquiry into the way the industry operates and into the contribution that the alleged coordinating practice has on competitive conduct. It is therefore very far divorced from the inevitability of competitive concern that is required for an 'object' infringement.

"Moreover, in the current context the enquiry into competition in this market is not a general 'fishing expedition' into conduct or characteristics that might lead to coordination, but a specific allegation that the RMSs were by their nature anti-competitive. If the publication of RRPs in this industry provides an independent route whereby manufacturers can learn about their rivals' pricing decisions over time, it becomes all the more difficult to establish that any dynamic concerns with manufacturer price collusion can be plausibly, let alone reliably, linked to the RMS."

DR SCOTT: Mr Howard, can you pause at the moment on this issue of transparency?

MR HOWARD: Yes.

DR SCOTT: The RRPs are very straightforward, as I understand it. The wholesale pricing is a good deal more complex. It's complex, as I understand it, both in terms of QN, you have the different levels of discounting, in terms of bonusing, and in terms of differential pricing as between retailers, which we may learn more about but in particular they may be quantitative, they may be bonus related and so on, so that it seems that you may be able to infer something from the RRPs, but the thought that you can infer a great deal about the complexity that lies behind the RRPs in terms of wholesale pricing and its differentiation between retailers strikes me as a little far-fetched.

MR HOWARD: Well, I am not sure what is far-fetched about it. One has to remember, for instance, the discounts that are available to the retailers are, for instance, there are volume discounts, the volume discounts are not likely to be different between one and the other.

Most of the discounts which manufacturers are likely to offer in terms of things like volume are things which are reasonably well known.

If you are saying: is it necessarily a precise relationship whereby you can say precisely what is the position?, you may be right, but you can infer -- we will obviously have to hear evidence about it -- I would suggest one can infer with a reasonable degree of certainty where the position is, and not least because of the low margins which everybody is aware are actually available on these products.

THE CHAIRMAN: Will we be hearing from someone -- the earlier passage that you took us to indicated that the RRPs are derived from an analysis of the actual retail selling prices observed in the market.

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

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

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

If one takes an obvious high street supermarket, the

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

THE CHAIRMAN: Is the method by which Imperial and Gallaher arrive at their RRPs something set by or agreed with the Revenue, or is that something entirely within their --

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

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

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

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

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

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

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

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

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

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

Then what are the cost prices, what are the cost to the manufacturers. The costs to the manufacturers are essentially the same in the sense that they are exposed to the cost of obviously the product, tobacco, and then you have manufacturing costs in the UK. Remember they are both UK manufacturers with UK employees and the costs that that involves. Then you have distribution costs. Of course they are not precisely the same, one may operate in a more efficient way than the other, but they will know just from studying public documents a fair amount about each other, so that -- and will also know from the public documents what the margins are that they are each seeking to earn. Then you know what the RRP is.

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

It's the RRPs, though, which provide a particular

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

Now --

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

MR HOWARD: Yes.

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

MR HOWARD: Yes.

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

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

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

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

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

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

that is to say independently of the RMSs.

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

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

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

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

Again, I would like to just take you to the reference to -- I've already shown you the reference, I think, to Mr Ridyard.

What Imperial sought to do was to offer incentive payments to the retailers which were contingent upon them setting shelf prices for Imperial's products in accordance with differentials specified in schedules attached to the trading agreements. As I've said, these generally reflected the difference in published RRPs.

Professor Froeb has explained that this aspect of the RMSs, the fact that they encouraged the retailers to pass on the benefit of wholesale price discounts to consumers, rendered them pro-competitive.

If we could just look in volume 3 at his first report, at tab 30, at the top of page 4 of his report, the first bullet point.

He explains:

"In particular, RMSs can provide a retailer an incentive to pass wholesale price discounts on to consumers. With a higher pass-through rate to consumers, the manufacturer faces an upstream demand that is more sensitive to price, or more 'price elastic' in the jargon of economics. The increased sensitivity to price can result in lower net wholesale prices (as well as lower retail prices) which, in turn, can cause rival manufacturers to reduce price. In this way, RMSs

can have pro-competitive effects and benefit consumers."

If you would turn on to paragraphs 27 to 28, he explains that:

"Normally, a retailer would not want to pass the entirety of a change in the manufacturer 's price on to consumers. Some of the price change would be absorbed by the retailer. At first sight, this outcome might seem to be competitively neutral in that a manufacturer's price reductions will not be fully passed on to consumers, but equally that a manufacturer's price increases will not be fully passed on to consumers. However, the key point to appreciate is how a low level of pass-through affects manufacturers' incentives to raise or lower prices. From the manufacturer's perspective, a low level of pass-through provides incentives to raise prices, since the price increase will not be fully passed on to consumers, and thus the loss of sales to consumers will not be as large. Similarly, if a manufacturer were to lower prices, the retailer would not generally lower them by as much at the retail level. This reduces a manufacturer 's incentive to lower prices since it does not produce a large increase in sales, and conversely creates incentives to reduce prices less since it does not produce such a large reduction in sales.

"With an RMS, retailers have incentive to pass more of a wholesale price decrease on to consumers than without an RMS. This can lead to a larger decrease in retail prices, and thus a larger gain in sales. Because a manufacturer 's price decrease leads to a greater increase in sales with an RMS than without, RMSs provide greater incentive for manufacturers to lower prices in the first place. When one manufacturer reduces wholesale prices, this typically results in a reaction from rival manufacturers, to further reduce wholesale prices. Manufacturers ' incentives to increase prices are reduced by the RMSs for the same reasons. Accordingly, an RMS can lead to lower wholesale prices and lower retail prices."

Now, that, a similar point is made by Mr Ridyard, if you turn back in the bundle to page 92, and we, although this is a section of the report under exemption arguments, the points being made apply equally to the first question you have to consider, the alleged anticompetitive by object.

So at paragraph 230, he explains that:

"There is a clear pro-competitive, price reducing and output expanding rationale for the RMSs. A manufacturer's interest, once it has sold its goods to retailers, is for the retailer to sell them as

efficiently as possible to the final consumer. Any margin the retailer adds on to the retail price, over and above what is necessary for the efficient distribution of the product, operates to the detriment of the manufacturer, whose goods will thereby be made less competitive against the goods of competing manufacturers. Similarly, if the retailer sells competing brands side by side, each competing upstream supplier has a legitimate commercial interest in taking steps to encourage the retailer to promote its brand at the point of sale at the expense of rival brands.

"However, in the absence of specific incentives provided by manufacturers, retailers have no reason to take into account the way in which their conduct affects the commercial interests of suppliers. For example, if left to their own devices, retailers will tend to raise their margins (and hence retail prices) above the levels that are optimal for manufacturers. This is known as the double mark-up problem and is caused by the fact that retailers have no reason to take into account the impact of their decisions on the profits of the manufacturer. This retailer self-interest is also detrimental to consumers because it leads to higher prices and lower volumes sold to them. Conversely, aligning the incentives of the manufacturer and the retailer would lead to lower prices and higher volumes being sold, to the benefit of consumers."

He refers to Professor Froeb and says:

"This is an important part of the context within which the RMSs should be understood. ITL's conduct across its trading arrangements with retailers is based on the pro-competitive motivation of seeking to make its products as competitively priced as possible against its immediate rivals. ITL had an interest to pay incentives to retailers (in the form of bonuses linked to the RMSs) to ensure that its brands were competitively priced against their immediate rivals because success in persuading retailers to act in this way would increase ITL's sales.

"This is the basic pro-competitive, output-expanding motivation that provides the clearest and most intuitive explanation for why ITL sought to include relative price schedules in its dealings with retailers. It is an explanation that falls clearly within the group of vertical restraints that manufacturers might seek to impose on retailers in order to make retail competition more intense than it would otherwise be."

In a similar vein in the next tab at paragraphs 3 to 5, where he explains at 3:

"This divergence between manufacturer and retailer

incentives provides a straightforward explanation as to why ITL might want to use an instrument such as an RMS to encourage the retailer to favour its brands over rival brands. Retailers would otherwise be more or less indifferent about consumers switching their purchases between ITL and Gallaher brands as long as the consumer continued to buy from that retailer, whereas for ITL such brand switching results in lost sales and profits. Hence, it is in principle clear to see how an incentive such as an RMS could be designed to change the retailer's incentives, rewarding the retailer for doing something (i.e, favouring ITL's brand) that matters to ITL but that would otherwise be of at best secondary importance to the retailer.

"This observation plays an important role in understanding why a manufacturer such as ITL might legitimately seek to introduce incentive payments to retailers to encourage them to set retail prices such as to favour its brand over rival brands. The adoption of such contracts also creates incentives for manufacturer A to reduce its wholesale price since the incentive payments increase the likelihood that the retail price of A1 will fall relative to B1's retail price following such a wholesale price cut.

"5. This, in essence, is what I understand to be

the benign commercial rationale for ITL's introduction of RMSs. ITL believed such incentives could encourage retailers to sell higher volumes of its brands than would otherwise be the case if it made such incentive payments. Because this motivation involves ITL seeking to sell higher levels of its output than would otherwise be the case, and because to do so it has to make incentive payments to its customers (i.e effectively to reduce the net price at which tobacco products are sold) I believe it is clear that this is a straightforward pro-competitive motivation. At a minimum, this pro-competitive motivation, which follows directly from GS's own identification of an incentive conflict problem that exists between manufacturers and retailers, must be included as part of the evaluation of the intended and actual impact of such arrangements on competition. I therefore disagree with" Professor Shaffer's conclusion, which he sets out.

I invite you to look at paragraph 6 as well. Now, at this stage, I would like to emphasise five points about the differential provisions.

The first point --

DR SCOTT: Can we go back to the double margin point?

MR HOWARD: Yes.

DR SCOTT: What you have told us so far is that there is

a dramatic difference between the very low margins, and 5 per cent has been mentioned, that retailers are making on tobacco products, and the 25 to 45 per cent that they are making on other products.

Now, you can explain that in terms of taking out the high percentage of tax and looking at the remaining amounts, but in terms of a simple approach to double margin, it seems to be a much greater problem in almost anything else that these retailers are selling than it is in tobacco where the margins are so sight for them.

You have mentioned the footfall argument as one of the reasons why a retailer might be inclined to take a low margin.

MR HOWARD: Is your question why are there low margins on --

DR SCOTT: No. There are low margins, I think we are all agreeing that there are low margins.

MR HOWARD: Yes.

DR SCOTT: What we are being told here is that:

"Any margin that the retailer adds on to the retail price [I am on paragraph 230 that you read out to us earlier on from tab 25] operates to the detriment of the manufacturer whose goods will thereby remain less competitive against the goods of competing manufacturers."

What we are looking at here is, as you have explained to us, a situation where both manufacturers are expecting retailers to trade at what are low margins compared to the other products that they are -- insofar as the double marginalisation problem occurs, it appears to be a much lower problem here than in relation to others.

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

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

And so on.

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

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

DR SCOTT: Yes.

MR HOWARD: That's --

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

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

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

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

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

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

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

MR HOWARD: Yes.

THE CHAIRMAN: We will resume in about 10 minutes.

(11.30 am)

(A short break)

(11.45 am)

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

about the wholesale prices is the RRPs but in fact also each of the manufacturers does publish wholesale price lists which are sent around to thousands of retailers, including small corner shops and so on, so there is in fact knowledge of what that wholesale price is. Of that, of course there are volume discounts which are unlikely to be particularly different, but then there are individual bespoke discounts, which is really what all of this is about, is trying to compete with the individual bespoke discounts that you perceive are being offered by the competitor.

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

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

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

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

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

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

the stores.

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

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

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

MR HOWARD: The conclusion on all of this is at

paragraph 62. (Pause).

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

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

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

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

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

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

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

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

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

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

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

MR HOWARD: Absolutely, yes. The point is off-invoice payments for pricing below RRP, again one doesn't necessarily know the precise strategy that the different retailers will operate in their discussions with the manufacturers, but what one does know is that if, for instance, Tesco's policy is to price below RRP and they are looking for support to do that, that Sainsbury's are going to be seeking to do the same because they are benchmarking against Tesco and so on, and equally one would anticipate that they are going to be having the same dialogue but with Gallaher and Imperial. In other words, there is no reason to infer that they are adopting a differential strategy where they say "Well, we want to price Gallaher below RRP but not Imperial", because they have no reason, there is no sensible reason why they would be doing that. Of course, the different manufacturer may be paying them a greater incentive to have a greater reduction. But that again comes back to the competition and what Imperial were seeking to achieve.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Then the next level down is, whichever answer you give to that, and we say there is only one, but it doesn't really matter, you have then got to ask yourself: what is the harm that's being said to arise from either type of arrangement, and the OFT's case is that the harm is that the way this is supposed to operate and was operating was that if you change your prices then the retailer has to change the price of Gallaher's prices. Or if Gallaher reduces its price, then the retailer has to reduce your price. So in other words they say: because that is what is required of the retailer, that disincentivises Gallaher from cutting its prices and incentivises Imperial to raise its prices.

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

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

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

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

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

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

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

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

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

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

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

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

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

Imperial's particular brand should be no more expensive than or at least [X]p less than the Gallaher brand. It is true that in a couple of cases, namely Sainsbury and in one or two of the differentials in the case of Morrisons and TM Retail, the differentials were expressed in terms that Imperial's brands should be +[X]p or -[X]p or parity or level with.

When you see the complete context, we suggest it is clear that it was not intended that the retailer was obliged to set prices at those levels, and that this was simply shorthand for providing that the prices should be no more than X more expensive than or X less expensive than, and so on.

DR SCOTT: Mr Howard, you talked earlier on about the extent to which Imperial and Gallaher knew about the way in which the market was structured, and at the moment you are talking about a situation in which we are looking at unilateral behaviour.

MR HOWARD: Yes.

DR SCOTT: But the decision talks about bilateral behaviour, and that does somewhat change the position, so that if you have got arrangements in which both Imperial and Gallaher have in relation to the same pairs of products. Again I want to be careful here not to use the words "similar" or "parallel".

MR HOWARD: With respect, that is incredibly important, and to see the shift in the OFT's case on this from the decision to the defence, the decision contains the assertion that there were parallel and symmetrical arrangements between Imperial and Gallaher. When the evidence points out that's wrong, there were not, they end up saying: oh, well, there were similar arrangements, and that's their case.

Now, "similar" is quite different to something where you say there is parallel and symmetrical, because it raises the question as to -- if they are parallel and symmetrical, you can understand it being said, ah, well, the retailer could follow both because they are set in such a way that actually they create a lock-step mechanism. Once they are not parallel and symmetrical, then you actually have got inconsistent requirements. So one has to consider: how does that operate? Indeed, that goes a long way to explaining why, to some extent, the OFT is now retreating from this and saying, oh, well, it's not a key part of our case to find that they were parallel and symmetrical. Essentially what they say is that the arrangements that Imperial had were bad arrangements by their object, and because they were bad it's even worse that they were parallel or symmetrical or now similar arrangements, but it is simply saying two

lots of bad agreements are bad. But one has to come back to ask, and that's the case we are meeting, whether or not the arrangement that Imperial entered into was bad, was unlawful by its object.

DR SCOTT: Would we be correct in taking into account the context of whatever understanding we later find out that there was into account in understanding the object of any agreement or arrangement that we find may have been in place?

MR HOWARD: I am not sure I follow. In my submission, because this is an object case, you have to look at the agreement or practice which is alleged. If the agreement which is alleged is that between Imperial and the retailer, you have to ask yourself what that was if what's being alleged is, well, there is a network of arrangements giving rise to the practice, which includes your knowledge of the arrangements that Gallaher had, so you are looking at it as a body, then yes, you have to ask yourself what knowledge was there, and if all that you are saying -- and this is all that -- I'll come back to this later on, but if all that's being said is, well, you had some knowledge in general terms of Gallaher's trading strategy, well, you have that knowledge in general terms from the RRPs, because the RRPs tell you which brands -- you can see from that which brands they

are -- well, what price level they are aiming for their brands, and of course they know your RRPs, so you know the extent to which they are seeking to set their prices for that particular brand above or below yours.

The question of how these differentials were, what was the agreement as to how they were to operate, because what the OFT says is, well, I mean, they agree that a large number of the agreements provide for relative maxima, but they say, no, that's not actually how it was intended to operate or how they were operated, and they point to correspondence which they say talks about specific price points and therefore that must show that you intended something different.

Now, this is one area where the adherence analysis is relevant, to see the extent to which the retailers were adhering on the basis of fixed differentials and the extent to which they were adhering on the basis of relative maxima.

The analysis you will find at {C3 tab 26}. This is Mr Ridyard's second report. There has been a debate between Mr Ridyard and Mr Walker as to the right way to go about it, but that's all fallen by the wayside, you will be pleased to know you don't have to worry about that.

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

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

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

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

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

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

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

to administer absolute maximum prices.

Perhaps you could turn to Mr Good's statement on this at tab 37, where he in terms addresses this point. He says at paragraph 16:

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

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

MR HOWARD: Yes.

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

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

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

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

One of the points about all of this -- sorry. Let me just make this point: one mustn't lose sight of also what this inquiry is about. The inquiry at this stage, when we are talking about whether or not these agreements, arrangements, concerted practices, whatever you want to call it, had an anticompetitive object, you have to ask yourself: are they themselves creating that anticompetitive object? The question is not: could you have done things in a better way? For instance, let's say one says well, we think from pursuing your strategy it might be better if you set absolute maxima, and that might even be more beneficial in creating a more beneficial competitive environment. That doesn't answer the question as to whether what you have done is anticompetitive.

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

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

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

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

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

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

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

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

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

MR HOWARD: Yes.

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

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

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

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

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

The only difference if you do it by absolute maxima is firstly it is incredibly complicated and query whether it can be done, but secondly it seems to be that, well, it would be all right if your strategy is to price against Gallaher but you don't tell explicitly the retailer that's what you are doing. In other words, so that you are constantly looking at the prices and when you see Gallaher's at £3.90 you say right, I want Embassy to be £3.88. That apparently would be okay, or maximum £3.88, but it's not okay to say "I want it to be at least 2p in that example less".

It's actually a distinction without a difference, it just goes to the mechanics. Ultimately you come back to not whether absolute maxima would have been better than relative maxima, but to the question whether there is some anticompetitive object in doing it this way. As I say, you can't actually -- I've explained, there is no point to it in any event, because it simply goes as to how explicit you are in your strategy, but it's always going to be the same strategy, particularly where what you are trying to do is to make yourself relatively cheaper than your competitor.

It's now become common ground -- when I say now, it was at the time of the decision as well -- that the retailers were free to set the absolute level of their retail prices. The OFT itself says that in the decision at various paragraphs with some references, 6.142,

6.220, and 6.250.

So the allegation of resale price maintenance has disappeared. That was an allegation at paragraph 13 of the SO.

It is important to recognise that this allegation has gone, because the decision and the defence and indeed the skeleton here are replete with references to Imperial monitoring prices, micromanaging prices, and instructing the retailers to set prices at specific price points.

Once the allegation of resale price maintenance has gone, what one has to ask in relation to all of these allegations on the evidence is: what actually are they going to? One can see that they are used sometimes in a prejudicial way. But the question is: what actually are they going to?

Now, communications about price between a manufacturer and a retailer and about the retail price are themselves perfectly normal. It is also the case that the retailers here themselves sought the administrative assistance of Imperial because they themselves often experienced difficulties in implementing their own pricing strategies.

Difficulties arise at a number of levels. One, they have difficulties because they have these different

pricing strategies, and they may not have been necessarily competent at all stages in implementing them. But also the effect of tax changes, they very often look to Imperial in relation to its products to ensure that the appropriate changes were being made.

Now, Mr Batty deals with this at {C3 tab 33, page 355, 6.4}:

"It's also the case ...(Reading to the words)... Price reductions funded by ITL."

A similar point is made by Mr Cheyne at paragraphs 35 to 37.

When you come to consider the correspondence, you will need to bear this evidence and other similar evidence in mind. When the OFT makes reference to Imperial instructing the retailers to adhere to specific price points, one needs to see that correspondence in context and set the correspondence in that context. What is happening invariably in those communications is that Imperial has been paying a bonus for a price reduction, the bonus is coming to an end, and so Imperial is informing the retailer in shorthand of that fact so that the retailer will want to put its price back up. It has nothing to do with being required to do something because Gallaher has done it, it's because we are no longer paying you and therefore this is what the

price should go back to.

Of course they were perfectly free to leave the price down, but what Imperial didn't want to happen is that they should carry on being charged for a tactical bonus when they no longer wished that bonus to be provided because they no longer wished the product to be price cut.

A lot of the correspondence that you will see relates to tactical bonuses being paid and withdrawn, and a lot of the correspondence therefore you have to see in the context of Imperial seeking to see that the bonus which it's providing for effecting a price cut is actually getting through and then, when it withdraws the bonus, making it clear that it no longer is requiring the price to be held.

While we have Mr Batty's evidence, he makes this point at the previous paragraph on page 355:

"The exact meaning of some of the ...(Reading to the words)... complex arithmetical calculations involved."

The final point at this stage that I want to deal with, but we have already partially covered it, is Gallaher price changes and opportunity to respond clauses. We say that Imperial never sought to restrict the retailers from changing the retail price of another manufacturer's products in the event of a wholesale price change by that manufacturer. That evidence or that submission is confirmed by the evidence of Fiona Bayley, which is worth turning up. I won't read it out, because I think that's covered by the confidentiality but it's in {C6, tab 69, page 440, paragraph 65}. We say that's absolutely right.

Because the differentials in Imperial's trading agreements, because they were maxima, there was no requirement upon the retailers to increase the prices of Imperial products following a wholesale price increase by Gallaher. At the most, at the very most, the retailer could, if it chose, increase the price, providing it was maintaining the differential. But it didn't have to do so. But one of the things is when Gallaher put up its price and Imperial was holding its price, which is what happened in the summer of 2002, Imperial then actually did step in and say "We want to widen the differentials". But what that correspondence shows is there was no expectation on the part of Imperial that its price would go up because Gallaher's price had gone up, and what's more it's totally counterintuitive when you bear in mind what Imperial was trying to do, which was to undercut Gallaher. It had no desire to put up the retail price simply because Gallaher's price had gone up. Of course it could

choose, if Gallaher put up its price, equally to put up Imperial's price. But that's just one manufacturer, who is affected presumably by the same cost factors, choosing at that time to put up its prices because it's able to do so, its competitor having done so. But it's nothing to do with the RMS arrangements.

DR SCOTT: In that circumstance, where they have increased the price of the Gallaher brand --

MR HOWARD: Yes. When you say "they"?

DR SCOTT: The retailer. A retailer has increased the price of a Gallaher brand because --

MR HOWARD: Gallaher has imposed a price increase.

DR SCOTT: Provided they retain the differential, in other words that any subsequent increase in the Imperial price maintains the differential, they still get their bonus, as I understand it.

MR HOWARD: That's right, but in other words, compare the situation without the RMS and with the RMS. Without the RMS the retailer may, where he sees one manufacturer put up the price, use that as an opportunity to increase his margins on the other manufacturers' products and put up the prices all the way, and say "Well, I am going to charge the same price". Where the RMS is there, he is in fact constrained in how much he would independently put up the price because if he puts up the price so he

loses -- so the differential is no longer there, and you have to remember it's a maximum, then he would lose his bonus. But in fact he can earn his bonus either by maintaining at least that difference or he can leave the price where it is and it would be greater.

THE CHAIRMAN: Unless he would thereby forfeit a bonus from Gallaher if there is a Gallaher agreement that the differential between that price and the Imperial price has to be not more than a certain amount. That's where we get to the parallel or symmetrical point. If Gallaher had said "Our brand must be priced not more than 3p more expensive than the ITL price" and then they put up their price, I know you say there the agreements didn't work in a way that would then require that retailer to increase the price of the ITL brand even though there had been no increase in the ITL wholesale price simply to enable Gallaher to maintain its differential, despite having put up its price. But it might be there that the obligation to raise the price of the ITL brand arises or doesn't arise, rather than --

MR HOWARD: I'm focusing on the moment on any arrangement with Imperial, in other words it's got nothing to do with Imperial, unless you say, well, there is an arrangement which Gallaher has, firstly, where Gallaher has required that the price of Imperial must go

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

But if one looks at Imperial's arrangements, there Imperial's desire is to undercut Gallaher. So if Gallaher puts up its price and Imperial chooses not to follow, the last thing it wants is for its price to go up. If you think about that for a moment, because if it's not putting up its wholesale price, what benefit does Imperial get from its retail price going up, in other words from the retailer increasing its margin? It gets no benefit at all from that, that's going into the retailer's pocket. So it has no desire for its prices to follow Gallaher. The only way in which you can infer such a desire is if you say, well, really what's going on is a conspiracy between the manufacturers and the retailers to force prices up. Once you say, well, there is no evidence of that at all going on, and that is not actually -- the thing is, this is a case very much of willing to wound but afraid to strike. It is not a case where it is said there was a cartel between the manufacturers and here is the evidence that we rely on to support that. What they try and say is: oh, well, this is akin to it. You have then to ask: what exactly do you mean by that, because you are not saying there was any communication between the manufacturers, you are not saying they actually had parallel and symmetrical arrangements any more which were known about, just something similar. What actually is the case?

THE CHAIRMAN: Is that a convenient moment? Finish off that point.

MR HOWARD: This point would probably take a few more minutes.

DR SCOTT: Just before you leave that point, from the point of view of the retailer, this is an opportunity to make an additional margin on Imperial cigarettes whilst retaining the bonus because they have retained the differential.

From the point of view of Imperial, because of what

we know about the relativity between the overall elasticity and the interbrand elasticity, Imperial isn't so concerned, providing that differential is maintained. Yes, it means that the retailer is making a greater margin, but there may be occasions when Imperial don't mind the retailer making a greater margin.

But what you are missing, through that arrangement, is the pass-through, because the pass-through disappears if the differential is maintained but the Imperial retail price goes up.

MR HOWARD: I don't think that's right, actually. It may be not to the same extent. If the retailer raises his margin, then the -- well, I suppose if you are saying -- the net effect is the product is more expensive to the consumer.

DR SCOTT: Yes.

MR HOWARD: But I think one needs to stand back a little bit from this. Take a situation where there are no RMSs and one manufacturer puts up its price, the retailer may choose to adjust and so it puts up its wholesale price, and the retailer is adjusting the retail price of the Gallaher brand. The retailer may choose to use that as an excuse to put up the retail price of Imperial, even though Imperial's wholesale hasn't gone up.

Now, insofar as the RMSs have any effect in that

situation, they certainly do not require the retailers to put up Imperial's prices, they do not incentivise the retailers to put up Imperial's prices. All that they do is, in relation to the situation where they can put up the prices because Gallaher has done so, they limit the ability to put up prices. In other words, to say -- it's very difficult to see how that could be anticompetitive when what you are still seeking to do is to keep Imperial's price down and to disincentivise the retailer from putting up Imperial's price when Imperial hasn't put up the wholesale price.

There is nothing anticompetitive in that, it's entirely the opposite, it's pro-competitive. The way the OFT seeks to get it into a pro-competitive scenario is to say there is a requirement to put up the price, and there is absolutely none of that at all. The most you can say is that if you put up the price and maintain the difference, you won't lose your bonus, but that is simply saying that there is something that inhibits you putting up the price as much as you might in order to increase your margin. But something that inhibits the retailer charging more, as I say, is necessarily pro-competitive.

THE CHAIRMAN: Shall we break there, Mr Howard?

MR HOWARD: Certainly.

THE CHAIRMAN: Thank you very much. We will come back, then, at five past 2.

(1.07 pm)

(The short adjournment)

(2.05 pm)

MR HOWARD: I am going to come in more detail later this afternoon, or first thing or some time tomorrow morning, to the way in which the agreements operated in the different conditions that one has to consider for the purposes of the theory of harm. So at the moment I am just looking at things in fairly general terms. So we were looking, before lunch, at the position where Gallaher puts up its price and Imperial hasn't put up its wholesale price. Is there anything in the agreements that requires the retailers, and that's the important thing, to put up the prices? And there is absolutely nothing. What's more, if the case was that Imperial was observing Gallaher price increases and was expecting its prices to be put up for some reason, one would expect to observe that in correspondence, which we say you simply don't. Equally -- well, I'll come back to some other scenarios.

I want to now consider, which is where the opportunity to respond clauses fit in, the scenario where Gallaher reduces the price of one of its brands, ie effectively it's involved in price cutting activity. Of course, part of the OFT's theory of harm is that Gallaher is disincentivised from doing that, because it can never get anywhere, essentially, putting it in very simple terms.

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

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

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

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

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

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

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

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

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

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

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

So in fact there isn't any real distinction, you will see, in the way things were operating in cases where there was an explicit or express opportunity to respond clause, and where there wasn't. Really, that's because the opportunity to respond clause as a matter of obligation is adding either nothing or virtually nothing. The reason is, the most it adds is the obligation on the retailer to say to Imperial "Would you like to respond? You might want to respond", but it doesn't create any obligation going beyond that. There is no restriction on the retailer in the sense that, before he implements a Gallaher price cut, that he has to give Imperial the chance to respond and has to do what Imperial says, or anything of that sort.

DR SCOTT: But if nothing happens, then presumably, according to the agreements, he loses the bonus based on differentials because a differential has been broken?

MR HOWARD: No. Again, completely wrong. No, that isn't what happens at all.

DR SCOTT: No, no, distinguish for a moment between what's in the agreement and what actually happens. I do appreciate that --

MR HOWARD: No, the agreements are providing that -- sorry. Perhaps I answered too quickly. What the agreements are anticipating is that Gallaher may reduce prices as a result of a promotion. What the agreements then provide is that there is an opportunity to respond but the bonuses continue to be paid even if Imperial chooses not to respond and therefore the differentials have narrowed as a result of that, or there may not be any

differential. It could be Gallaher, previously Imperial was supposed to be below Gallaher; now it's actually above. The bonus may still be paid because the differential then would be based upon what the previous position was if Imperial doesn't respond.

The retailer doesn't stand to lose his bonus as a result of the Gallaher price cut. The only circumstance he loses his bonus is if there is a Gallaher price cut, Imperial responds and he then chooses not to implement the Imperial response because, for whatever reason, he doesn't think it worthwhile.

I think within what you said to me, there is a further point which could arise, never arose in practice, because this isn't how anything operated, where one could say: well, what happens if there is a Gallaher price promotion, the retailer says nothing, carries on pricing as he was previously, in other words the differential has widened; would he then lose his right to bonus because he had not given Imperial the opportunity to respond?

DR SCOTT: That's my point.

MR HOWARD: The thing is, that is theoretical and not real because nobody actually operated any of this on that basis, in the sense that Imperial knew exactly what was happening, so that the difference between whether you

have told them on Friday that Gallaher on Monday have a price promotion or you are discovering it on Monday didn't make any difference to anything.

MR SUMMERS: Sorry, Mr Howard, may we just, again, since it's Day 1, be clear about this.

MR HOWARD: Yes.

MR SUMMERS: What you are suggesting when you use the words like "spotted" are that these promotions will only partly overlap with each other, because I think in the papers I seem to remember reading they take time to set up, they have to be spotted and then there have to be negotiations and things have to be printed and stock has to be organised to give effect to the promotion. So that inevitably manufacturer B will start their promotion later than manufacturer A, and presumably may go on for longer than manufacturer A.

MR HOWARD: Sorry, I am not sure I'm quite there.

MR SUMMERS: Shall we say Gallaher start, they cut, their promotion runs for a period of time, they decide when the length of the promotion is predetermined. Manufacturer B comes in, they start later than manufacturer A, Gallaher. Presumably their promotion can run on beyond the length of time.

MR HOWARD: Yes.

MR SUMMERS: Yes, and that's how it may --

MR HOWARD: That's how competition --

MR SUMMERS: That's how competition works, and the duration of those promotion periods is a matter for discussion between the manufacturer and the retailer.

MR HOWARD: And of course it's going to depend on -- the manufacturer may launch a promotion and he will have to decide how long he wants to maintain it. He may in the first instance launch it for a particular period, he finds it's particularly successful, and so he may extend it. It just depends upon what he is trying to achieve, which is presumably usually -- well, he is obviously trying to increase sales and increase market share.

Obviously what happens, if you are Imperial, and this is very important to sort of just think about in the context of opportunity to respond. If you are Imperial and you see Gallaher -- I'm using Embassy and B&H simply because they are brands that we probably all just remember, easy to keep in your mind whose they are, they are not actually -- I use them for that reason -- necessarily the best examples, because the brands where very heavy competition was taking place was actually Dorchester and Richmond in this ultra low price market, at least I always forget which was which so I'll stick to Embassy and Benson & Hedges.

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

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

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

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

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

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

lower prices.

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

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

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

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

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

MR HOWARD: Sorry?

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

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

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

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

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

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

differentials.

As you can see, just casting your eye down there, the brands which were the subject of this are generally one sees maxima price differentials, but in one or two cases you have Superkings family for instance, "level with on".

If you look at the context of this, it's perfectly clear that ITL doesn't have a requirement that Superkings must be priced at the same price as Berkeley, B&H, Superkings and Raffles, but "level with on" is intended here to mean that it mustn't be more expensive than. There is absolutely no rationale for suggesting that ITL was trying to require Morrisons to price at parity. Their concern was always ensuring that at least the differential was maintained. That point is confirmed by Mr Eastwood of Morrisons at paragraph 16 of his evidence, which is in core 8, tab 94, page 436.

Come back to the opportunity to respond clause. If you would turn to tab 85, this is the agreement that was in place from 1 August 2002. It is in slightly --

THE CHAIRMAN: Just going back to that, then, was that an agreement in which there wasn't also one of these bonuses for pricing below RRP, or would that have been in a different agreement?

MR HOWARD: I am not sure about that.

THE CHAIRMAN: So how this worked, then, just so I understand it, is that, looking at page 2, you have the factors or the parameters in 2, 3 and 4, there are specific sums mentioned and then number 1, the relative pricing, that is ...

MR HOWARD: Are you asking, what is the level of bonus?

THE CHAIRMAN: That's what's set out on page 4, is it?

MR HOWARD: Yes.

THE CHAIRMAN: Page 4 is the appendix 1, so it's those numbers, those pence per pack sold, provided that you stick with the pricing sheet on page 5.

MR HOWARD: That's right.

You can see generally it's pretty low.

DR SCOTT: What you are saying is that whereas in 1 on page 2 there is a reference to response, there isn't in there a provision which says "Inform us if this has happened".

MR HOWARD: Absolutely. So if you take this agreement, you would have to say, well, it must be implicit in here that Morrisons have to tell Imperial, that's absolutely hopeless if that's what's being said, we could go into the law on implied terms, but to suggest such an implied term would be a very, very tall order.

This isn't providing anything about Morrisons doing anything, it's just that ITL is agreeing to maintain the

bonus levels, should we elect not to respond to other manufacturers' pricing initiatives.

DR SCOTT: So if in practice Morrisons adopt a Gallaher pricing initiative, and then Imperial come back and say "Hold on a moment, you are not working by the page 5 differentials", Morrisons can say "Yes, but we have a Gallaher pricing initiative and therefore you must go on paying the bonuses if you don't respond".

MR HOWARD: Yes, that's right, it's just the reason these are not models of drafting, in the sense that it doesn't fully explain, well, what -- assume there is a Gallaher price initiative and the price therefore of the Gallaher product has gone down, Imperial shrugs their shoulders, what is it that Imperial is expecting Morrison to do in order to earn the bonus? What it's expected to do is to continue to price on the prior basis, before the Gallaher price promotion. So that in other words if, maintaining the differential had meant it was pricing Embassy at £3.90, if it carries on pricing Embassy at £3.90, notwithstanding the fact that B&H is in at £3.87, they have still earned their bonus.

You might think, well, that's commercially a little bit odd, but it's not really because even in that situation Imperial is concerned to ensure that it doesn't get unfairly prejudiced, for instance by the

margin being put up or whatever it is, so it still comes back to this point that there are the two drivers, one is to try and ensure that the low wholesale price gets reflected in the retail price with the retailers not seeking to earn excessive margins at Imperial's expense, but secondly trying to maintain the differential with Gallaher. That's the key point. But sometimes you can't do that because Gallaher are price cutting and it's just not worth -- or Imperial doesn't want to spend the money.

THE CHAIRMAN: Do these sort of temporary promotional efforts feed in at any stage, either immediately or over time, to the RRPs?

MR HOWARD: The answer is it all depends. Where a manufacturing price increases, that generally will change the RRP. Where you have a temporary promotion, that will not necessarily cause any change in the RRP. Now you might say, hang on, what about the Treasury position, how is that working? The answer is that -- we may have to look at this a little more closely in the light of some of the questions about it, so subject to that caveat, I'll explain how I understand it to work.

Where there is a price promotion, firstly your RRP may still represent what you anticipate to be the average selling price, notwithstanding the promotion.

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

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

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

consumer.

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

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

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

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

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

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

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

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

DR SCOTT: That's right.

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

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

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

MR HOWARD: Firstly there is no evidence to suggest that. We have to be careful. One can postulate all sorts of things. It's rather like Professor Shaffer and the OFT postulating that, well, if they were paid lump sums then they might be prepared to do this. The answer is, well, yes, you can postulate that, but were they? The answer is nobody suggests they were.

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

MR HOWARD: Yes.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

MR HOWARD: I apologise to whoever's --

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

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

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

MR HOWARD: I am sorry, and if I have been doing that on other occasions I will try to remember.

So the format of this agreement is slightly different in the sense that what you have is a single payment for the various things, so you can see the first thing was product listing and availability. Over the page is -- I don't need to go into the detail, you can yourselves see that there are a lot of different things going on. You then have pricing and merchandising.

You can see in relation to pricing that the differentials now are absolutely clearly maxima and we suggest, there is no change between the years and it was obvious at all times that was the case.

The opportunity to respond -- well, if you look under "Pricing", you can see the opportunity to respond clause:

"Should our competitors reduce their shelf prices, Imperial Tobacco should be allowed to respond in order to realign with the price list differentials. Should any additional funding be agreed to support a response to competitor activity, it should be removed once that activity has ended."

Again, that sort of statement is really only a statement of the obvious, so that if we choose to fund, in order to support a response to competitor

activity, when that activity ends, then it can be removed. In other words -- and this is what you will find in the correspondence -- they support a price reduction and then remove it once the reduction ends.

Unless you have any questions on that, I was then going to turn to the Sainsbury one.

MR SUMMERS: May I just ask, again it's another Day 1 question, it does come up again: what is understood by natural price list differentials in the pricing section, line 2?

MR HOWARD: What is being referred to there is the -- the word "natural" is obviously, to people not involved in this, a slightly odd word -- price list differentials that one observes in the RRPs. In other words, that's what you have to remember is very important, that historically brands have competed -- maybe this isn't particularly odd -- but historically the manufacturers have always sought -- whether always, but in recent years they have sought to compete with one brand matched against another, and so then in the RRPs you see where each of them is trying to price vis-a-vis the other their brand. That's what they are referring to as the natural price list differentials.

DR SCOTT: I think Mr Batty refers to this in his paragraph 4.37 in his first ...

MR HOWARD: Sorry, who does?

DR SCOTT: Mr Batty.

MR HOWARD: Yes. I was worried from the way you mentioned it that I had got it wrong, but I don't think so.

DR SCOTT: I think that's right.

MR HOWARD: It is broadly consistent with that. "Natural" is simply reflecting the fact of the way in which the manufacturers individually are setting(?) themselves.

Sorry, I overlooked, and I should have done, that on page 463 in the Morrisons agreement, after the opportunity to respond clause is the provision that:

"With the exception of the application of either Budget or manufacturer price increases, Imperial Tobacco investment should reduce in line with any upward movement in shelf price."

What that was concerned with is the situation where the, other than where you had Budget or manufacturer price increases, where the retailer was seeking to move prices up. That would be as a result of a, one would infer, Gallaher price increase, the retailer pushing up the price. In other words, it was making it clear that if, as a result of your retailer decision to put up shelf prices, then we are not going to pay in the event, again, that our differentials thereby are reduced. In other words, it's making it clear that we are not

expecting you to put up the prices, and insofar as you do and the differentials are reduced, then we are not going to be paying you the bonus.

Can we then go quickly to Sainsbury's in SO annex 18, tab 17, you will see on the first page this is what's described as a copy of the trading agreement, and just if you turn the pages you will see it's covering various different things. The relevant part for present purposes is on -- I can't read the pagination in mine, but there is a slide which is "Prices", about halfway through.

(Pause)

DR SCOTT: It looks like that? (indicated)

MR HOWARD: Yes, exactly.

THE CHAIRMAN: That's 37.

MR HOWARD: It must be 37, yes. So you can see:

"Price differentials maintained between ITL and competitor brands where appropriate. Bonuses to be paid based on selling price. ITL to be able to respond to any price promotions where appropriate within a reasonable timeframe."

Now, on the very last page of this section is the price list differentials, and you can see that way that this was expressed -- again it's all in very shorthand terms -- is if you take B&H Kingsize, that's minus 3p against for Embassy No 1 Kingsize, and so on. From this, the OFT infers that or concludes that the price difference was to be fixed at minus 3p, whereas in fact when you think about it for a moment, it's utterly obvious that where they write minus 3p, what they mean is at least minus 3p. There is absolutely no reason why Imperial requires the price of Embassy to be precisely 3p less. Its purpose is achieved by it being at least 3p, and there is nothing in the agreement that says it has to be fixed at that differential and no more, and we would suggest it's obvious that it's intended to be at least that.

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

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

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

"SSL [Sainsbury's] accept that ITL make investments in their brands based on two fundamental criteria: shelf price relativities and the absolute levels of those shelf prices and the pricing strategy is to replicate the differentials that exist naturally between our brands and those of our competitors."

Those are set out in appendix 5.

"Based upon the shelf prices and the achievement of the price list differentials, ITL will continue to pay the bonuses framed in the example price panel."

Then it is explained:

"The investments consist of two elements: ongoing and tactical bonuses, both paid retrospectively."

Just stopping there for a moment, the tactical bonuses are where you specifically go in to try to ensure that the price of a particular brand is priced at a low level, so that's why it's called a tactical bonus. There is a danger, the OFT seeks to confuse the tactical bonuses and the bonuses to achieve the shelf price relativities, but here you can see very clearly they are not the same.

Then it's provided that:

"Ongoing bonuses will be paid based on SSL's shelf prices remaining at their current levels and should be reduced in line with any upward movements excluding MPI

or Budget increases."

So that is a similar provision to that which we found in the Morrisons one, which is reflecting the position that things will change if the shelf prices go up, excluding as a result of MPI or Budget increases.

"Tactical bonuses are paid to reflect additional investment, usually in response to temporary or sustained competitor activity, and should also be reduced once that activity has ended. From time to time, ITL's competitors may reduce the shelf price for their brands. SSL should allow ITL the opportunity to respond in order to realign with the differentials. Should ITL choose not to respond, those differentials may widen."

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

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

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

(3.15 pm)

(A short break)

(3.25 pm)

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

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

Then under "Ongoing Bonuses" it was provided that:

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

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

So --

THE CHAIRMAN: You read "excluding MPI or Budget increases" as meaning excluding Imperial MPI or Budget increases, not either Imperial or Gallaher?

MR HOWARD: Absolutely. It doesn't make any sense at all to read into that excluding Gallaher MPIs.

It's talking about Sainsbury's shelf prices for Imperial products. There is nothing here where you can say what they are talking about is Sainsbury's shelf prices for Gallaher products. Imperial simply were -- I was going to say, but again I would be making a point against myself, Imperial couldn't care less if Sainsbury's put up the price of Gallaher products. They are delighted if Sainsbury's put up the price of Gallaher products, because what they want is Sainsbury's then to hold their prices at the pre-existing shelf prices enhancing their competitive position.

The other thing I wanted to turn up was Fiona Bayley's witness statement, which is in fact -- I didn't expressly refer to it because I was concerned it was confidential, but the actual witness statement isn't, and that's in volume 6 of the core bundle at tab 69. {C6/69/442}

DR SCOTT: Are you wanting us to keep the Sainsbury's agreement?

MR HOWARD: Because she is referring to it, you might want to, but it's not necessary. It's paragraph 78 on page 442 of the bundle. She refers to the 2002 trading agreement and quotes from it, and then says:

"This means that if we implemented a tactical price move for a competitor, Imperial would see this price hit the shelf and want an opportunity to respond. I would not initiate this. Imperial would say 'well, you have reduced the price of Dorchester, can we do the same on Richmond? Paul and I would normally have a telephone conversation confirmed by email."

So in other words, the Sainsbury's buyer understood the position to be exactly as we have said, which is that she was free to accept for Gallaher to promote the price and she was free to accept for Gallaher to provide a tactical bonus. That of itself had no effect whatsoever on Imperial, but in that event she would not do anything vis-a-vis contacting Imperial, simply if Imperial spotted the position then they would ring up and you would have a discussion to see whether or not Imperial wanted to themselves fund a price cut. All of that is entirely pro-competitive behaviour.

Against that background, we come to the theory of harm. For this purpose it's going to be useful if you have to hand the decision, and you may also want to have

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

(Pause)

Before we look at the decision, firstly I ought to explain, it is going to be necessary for us to follow through with some care what is the theory of harm as it's explained in the decision. So I apologise that we will have to do that in a rather painstaking way.

The first thing to note is that it is common ground that the trading arrangements here were novel and, to use the words of Professor Shaffer, he describes them as unusual and idiosyncratic, and they have not previously been considered in the economics literature.

That of itself does not preclude necessarily the finding of an object infringement. No-one is saying that. But it does mean one's got to be particularly careful where you have some new form of agreement which you haven't seen before if you are going to classify this saying it's necessarily anticompetitive. And that explains, I would respectfully suggest, why the OFT seeks to say that this is akin to a horizontal cartel, because we all know that, and this is what they say -- a horizontal cartel is a bad thing, so it must follow that if this is the same as, or akin to a horizontal cartel, it must be a bad thing.

As I said, Mr Brealey is going to address you

separately on the right legal approach, but can we just see how the OFT has put the case.

In summary, you will see that the OFT is contending that the RMS or the trading agreements were implemented as imposing parity or fixed differential requirements so that there was a requirement that the price of brand X must be the same as the price of competing brand Y, or a requirement that it must be Z pence less than the price of competing brand Y.

If you take the decision, one needs to look quite carefully at the way the matter is put, at page 10, paragraph 1.4, and one tries to extract some of the key things, you see that in 1.4 they say:

"The infringing agreements comprised in each case an agreement or concerted practice between each manufacturer and each retailer where the manufacturer co-ordinated with the retailer the setting of the retailer's retail prices for tobacco products in order to achieve the parity and differential requirements between competing tobacco brands in pursuit of the manufacturer's retail pricing strategy."

The next sentence is particularly important:

"The infringing agreement between each manufacturer and each retailer restricted the retailer's ability to determine its retail prices for competing tobacco products."

Now, immediately one has to think and ask: well, how did it effect such a restriction? What is the restriction that you are complaining about which you say is necessarily anticompetitive?

If you then go on to 1.8, this is where they define what they say are the elements of the infringing agreements and the five elements, and you will see, looking at each one of those, that in a number of cases it's actually rather difficult to see what it is out of any of that which is alleged to give rise to any restriction.

For instance, take the first one, the manufacturer's strategy in relation to retail prices. Well, the fact there is a strategy for Imperial to try and undercut Gallaher, so what? Then one has the written trading agreements, and the important thing is what's said about those, that it would price the brands, it would, according to the parity and differential requirements. So the language of obligation.

Then you have contacts regarding retail prices of the manufacturers' brands, retail prices of the competitors' brands and retail prices of competitors. Payment and withdrawal of bonuses to incentivise the retailer to set its retail prices. Then frequent and

detailed monitoring.

Now, if you then go to 1.10, the relevant provisions of some of the written trading agreements were phrased in terms of parity and fixed differential requirements, where others were phrased in terms of maximum differential requirements.

In response to the statement of objection, some parties submitted that, irrespective of the language used, the parity and differential requirements merely imposed an obligation on the retailer not to set retail prices above a maximum price level, and that was not consistent with or did not lead to the manufacturer stipulating a fixed or minimum pricing obligation. Some parties submitted the notification of specified retail prices was merely a form of suggested or recommended retail prices."

The next paragraph is important. They acknowledge that:

"They were ostensibly expressed as maximum, and in certain communications instructions and/or requests were occasionally expressed as stipulating maximum prices or maximum differential. However, taking the evidence as a whole, they say the agreements in fact provided for parity and fixed differential requirements, implemented by communications from the manufacturer to the retailer

pursuant to which the retailer was to move to a specific price point."

So there they seem to be saying, notwithstanding the terms of the agreement, which ostensibly are expressed in one way, the actual implementation is different, and ostensibly presumably is intended to be some sort of allegation that the agreements are a sham.

If you go on to 1.12, then the restrictive nature of the infringing agreements resulted from the linking of the retail price of the competing brands since that restricted the retailer's ability to determine its retail prices for the manufacturers' brands and those of competing link brands to any extent that differed from the prescribed parity or differential.

Stopping there for a moment, here they are introducing their case that there is a restriction on the retailer's ability to determine the retail prices.

Now, if you then say, go on to the next paragraph, that is explaining that that was capable of restricting competition, that's their first sentence, and they explain:

"Such a requirement precluded a retailer from favouring the brand of one manufacturer over those of another, and was capable of significantly reducing uncertainty both for a manufacturer which imposed the

P&D requirement and a competing manufacturer which observed the consequences of such requirement or had knowledge of such requirements as regards the retail prices of the manufacturers' brands and those of the competing brands. The long-term implementation of the P&D requirement would therefore reduce the incentives both for the manufacturer imposing the requirement and the competing manufacturer to engage in interbrand competition."

We have then a detailed analysis of this at section 6, paragraph 214. It starts at page 129, which is headed "The restrictive nature of the infringing agreements". What they do is they have, at page 131, a section which is headed "The restrictive nature of a manufacturer's retail pricing strategy operating as a parity or fixed differential requirement", and at page 136, they have the restrictive nature where it's a maximum differential requirement.

Their case is that, and it responds to a point that we were discussing this morning, it's not dependent upon the parallel and symmetrical allegation. So they start off by saying this is a bad thing and it's just a doubly bad thing if there was parallel and symmetrical.

If you then go to 212, I won't read it all out, 212 is explaining what they mean by a parity or fixed differential requirement.

Then 213 is important:

"As stated in the SO, a parity or fixed differential requirement restricts a retailer's ability to determine the retail prices of competing linked prices because the relative prices of competing brands are fixed on the basis of the required parity or differential. If a parity or fixed differential requirement is implemented, an increase or reduction in the retail price of one brand leads to a corresponding increase or reduction in the retail price of the competing brand by an equivalent amount."

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

They then explain, in 214:

"A parity or fixed differential requirement is capable of giving rise to significantly increased certainty for a manufacturer imposing a requirement, manufacturer A, that any change in the retail price of its brand, brand X, will be matched by a corresponding change in the retail price of the linked competing brand. In the absence of a requirement, manufacturer A can expect if it raises the wholesale price of brand X,

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

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

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

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

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

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

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

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

going to happen.

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

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

So you see at paragraph 11:

"Fundamentally the P&D requirements constituted agreements between manufacturers and retailers which required [note that word] a horizontal link between two rivals' retail prices. The appellants seek to obscure this basic nature of the requirements by, for example, discussing differently formulated P&D requirements seeking to emphasise the vertical aspect to the agreements or preferring various explanations for the existence of the requirements. However, not even the appellants would surely dispute the fact that an agreement between two manufacturers always to price their rival products at identical levels to each other is presumed to be anticompetitive."

So you have a situation where the manufacturers are always pricing at identical levels. Then they say:

"There is no reason in logic or principle or even persuasively proffered by the appellants, who failed to grapple with the fundamental problem with the infringing agreements, why the position should be any different when manufacturers use retailers [so that is what is being alleged, the manufacturers are using the retailers] to provide the same horizontal link."

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

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

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

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

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

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

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

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

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

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

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

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

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

MR HOWARD: I am sorry?

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

MR HOWARD: You are right, but it's not in any sense in relation to what we are discussing a material qualification. In other words, they are using "identical", it covers a situation including where there is a differential. That I agree, I had understood that. But the important thing is that that differential is fixed for all time, or for the duration of the agreement, whatever happens, so that their case is Gallaher can't put its price down, and you, Imperial, can put up -- Gallaher can put up its price knowing it can bring you up, Imperial, at least so that it doesn't suffer too much -- well, it doesn't suffer any disadvantage from its current position, and you, Imperial, can do the same.

But it is absolutely clear on this part of the case, in paragraphs 11 and 12, the fundamental proposition. The reason I really want to emphasise that, you are going to see that, although this is the fundamental proposition, because they realise that this is factually nonsensical, we then get what is a different case, which is not specifically addressed but what they are saying is: oh, well, it somehow has an adverse effect on competition that Imperial might be able to reduce its prices more effectively in competition with Gallaher, and that that which is pro-competitive, one might think, that somehow leads to an anticompetitive effect.

But that is not part of the fundamental proposition it's actually part of a case which one can pejoratively say is all done by smoke and mirrors or sleight of hand, but they set up this case which one can understand what it is is being said, and then they look at something which is quite different and say, oh, well, that's nevertheless still the same and covered by our theory of harm. It isn't. It's, as you will see, quite

different.

Now, I was taking you to Professor Shaffer, and to his 2010 report, which is at tab 65. Paragraph 17, this is part of his summary of his conclusions, and he is explaining his conclusion, which is as to why a P&D is expected to have anticompetitive effect. At 17 he explains:

"The manufacturer's trading arrangements would be expected to introduce interbrand competition from the moment they are established ..."

Stopping there for a moment, if Professor Shaffer's point is right in relation to the facts, he is saying from the very moment these agreements are established there is an anticompetitive effect. Well, one really would say it's pretty surprising if Professor Shaffer is right that none of this can be demonstrated in practice. One would have thought there is something wrong with the theory, or that the facts are different.

Then one sees:

" ... because each manufacturer's trading arrangement would reduce the incentive of the rival manufacturer to compete and increase the incentive of the manufacturer with whom the retailer has the arrangement to raise its wholesale price.

"In the former case, incentives to lower wholesale

prices would be reduced because the rival would be unable to shift relative retail prices in its favour."

That's the important thing. What he is saying is it's not possible for, where these P&Ds are there, Gallaher to shift relative retail prices in their favour, to which the obvious riposte is certainly (a) they were trying to do it and (b) there was nothing in the agreements to stop them, they would reduce their price, the only thing that might upset the apple cart from Gallaher's point of view is not that the retailer did anything independent of Imperial, but that Imperial then implemented its own price reduction.

Well, that has nothing to do with an inability to shift relative retail prices; it's to do with competition operating in favour of the consumer but possibly against Gallaher.

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

MR HOWARD: And so does the OFT.

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

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

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

Now, one of the reasons for that is that, firstly you have to remember we are in an object case, we are not looking at what is the actual effect, that's because the OFT did an effects analysis, couldn't find anything, but they are not saying, well, it did in fact have an effect. You are then having to say, well, we have to actually think about how this operates. What Imperial is seeking to do is to lower the price of its brand. If you were to say that, well, you have then incentivised the retailer to price your product below that of Gallaher, if you say, well, if he accepts your incentive, then by doing that, at least in order to maintain the bonus, he cannot reduce the price of Gallaher.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Then in the decision and in his 2010 report you will see some reference to opportunity to respond, and I'll come on to that. That's said to just be uncertain compliance with a lock-step obligation, so in other words there is still a lock-step obligation but just you don't, it's not 100 per cent certain it's complied with, to a new case via his response to the experts' joint statements and his 2011 report, which seems to just be saying: well, there is some general expectation that Imperial can undercut and that will have an adverse effect.

But it's important to see that the case has always been about this lock-step. I showed you paragraph 17 of his 2010 report. If you look at that same report at paragraph 120, you will also see the position set out very clearly, where he talks about -- no, sorry. It's where he uses the lock-step. It may be that that's the first time he uses "lock-step". That you see at 120, that's the third line, his reference to "lock-step".

Now, the lock-step mechanism which Professor Shaffer is putting forward and is at the heart of the OFT's theory of harm is one where you have got the -- what one is looking for is the constraint upon the retailers which they say then causes a response by the manufacturers, which essentially is to disincentivise them.

So you have the situation where Gallaher implement

a wholesale price increase; what, on this theory of the case, is required is that whenever they put up the price, then the retailer has to increase the corresponding Imperial brand by the same amount.

Similarly, if there is an Imperial wholesale price increase, then similarly Gallaher has to go up; when there is an Imperial price decrease, Gallaher has to come down; if there is a Gallaher reduction, Imperial has to come down.

The other point to note on the retailers' position, just to pick up that point: of course the retailers, their main objective -- at least for the supermarket chains, who are amongst the major parties here -- is to benchmark their competitors, and they have no interest in funding individual price cuts. But equally, it makes no sense to think that they were undertaking not to react to, in their own interests, what their competitors were doing and, again, there is absolutely nothing in the agreements which will support that.

Now, it is necessary to nail this point that they are talking about a lock-step and, if there was any doubt about it, you can pick it up in the OFT's defence, which is in core 4, where they criticise us for misunderstanding their case.

{C4, tab 46, page 227}, you will see at the foot of

page 227 they refer to the notice of appeal and then say:

"ITL argues that if Gallaher reduced its prices, a retailer was free to reduce the [there they must mean its wholesale prices] a retailer was free to reduce [there they must mean the retail price of] the Gallaher brand without loss of ITL's incentive payment. That point, which is derived from a mistake made by ITL in [a particular paragraph of] the notice of appeal and repeated, concerning decision 1.13, is addressed at [the various paragraphs]."

You will remember paragraph 1.13 of the decision, which we looked at a little while ago, was the paragraph explaining the restriction on the retailers. So in footnote 45 they explain the position. They say:

"Paragraph 1.13 states that such a requirement, that is the restriction on a retailer's ability to determine its retail prices for competing linked brands, precluded a retailer from favouring the brand of one manufacturer over those of another. That was repeated in paragraph 6.7 of the decision."

Then they helpfully give us an example:

"An example of the situation is this: if manufacturer A requires the retailer to price A's brand, X, at 3p above manufacturer B's brand Y, that fixes A's

preferred price relationship between X and Y. The retailer is precluded from favouring Y over X because, even if the price of Y is reduced, the retailer is bound to change the price of X accordingly in order to maintain the price relationship between those brands determined by A. ITL misses the point entirely."

Well, we don't miss the point. We understand. We didn't before, we certainly understand here. It's made crystal clear what the case is. It is, the retailer being precluded, he's bound to change the prices.

The same point is in fact made in the skeleton at paragraph 12, and I've already shown you that.

Professor Shaffer's 2007 report also makes the point very clearly, that's at tab 64. Actually we looked at paragraph 17 already. Sorry, the 2007 report, I beg your pardon. If you go back to the 2007 report.

THE CHAIRMAN: At tab 64 of bundle 6?

MR HOWARD: It's tab 64, I beg your pardon, and it's paragraphs 16 and 17 there:

"In the absence of parity and differential requirements the retailer is able to raise the price of the manufacturer's product without having to change the price of competing products. Typically one would expect the retailer to increase the retail price of the manufacturer's product in response to a wholesale price increase. Since the wholesale price increase increases the retailer's marginal cost, since the higher retail price affects consumer demands, not only for the manufacturer's own product but also for all competing products, the retailer would typically also want to change the prices of the competing manufacturer's products. Whether he will want to increase or decrease these prices depends on the trade-off between two opposing considerations", and he explains what those are.

In 17 he explains:

"In the presence of P&D requirements, the retailer is not able to raise the price of the manufacturer's product independently of the price or prices of the competing products. In this case, if the retailer raises the price, it must also raise the price of the competing products."

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

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

account when considering how to change prices, retail price of competing products.

MR HOWARD: What he is saying is that where the Imperial price goes up, without a P&D requirement, as I understand it, he is saying the retailer may -- I mean, he is actually saying that he may or he may not want to put up the price of the Gallaher product. The reason he may want to do it is, under cover of Imperial's price increase, he may use it as an opportunity to increase his margins on Imperial's product, but he may have competing considerations which mean he doesn't want to do that.

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

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

want to raise or lower the prices of the competing products in response to a wholesale price."

In fact you are probably right, he is not quite reflecting the point that I made, but the bottom line is he is saying that if one manufacturer puts up his price, then the retailer may or may not want to put up the price of the other product, and he is contrasting that with his assumption of the P&Ds that the retailer has no choice, he is not able to raise the price of one independently. Not able. He must also raise the price of the competing product.

THE CHAIRMAN: Yes.

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

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

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

THE CHAIRMAN: Is that a good point to break?

MR HOWARD: It is.

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

(4.30 pm)

(The court adjourned until 10.00 am on Thursday, 22 September 2011)