IN THE COMPETITION APPEAL TRIBUNAL

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

Victoria House,
Bloomsbury Place,
London WC1A 2EB

22 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 2)

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.

Thursday, 22 September 2011

(10.00 am)

Opening submissions by MR HOWARD (continued)

DR SCOTT: Mr Howard, yesterday I realised some deficiencies in my cross-referencing from the evidence to the bundles, and there were two particular areas. The first comes up in transcript 40, lines 1 to 7, where you referred to certain public documents when you were talking about transparency, and it would be helpful -- not immediately but at some stage -- to know whereabouts in the bundles we might find those.

MR HOWARD: Yes. I don't have the transcript to hand. In due course?

DR SCOTT: Yes, in due course, it's not urgent.

The other is in transcript 55, lines 2 and 3, where you referred to the publicly available wholesale price lists.

Again, although I can recall references to them and to the non-bespoke discounts as distinguished from the bespoke discounts you mentioned shortly afterwards, again I couldn't immediately remember whereabouts in the bundle we would find those.

MR HOWARD: I don't think that they are in the bundles.

DR SCOTT: Right.

MR HOWARD: We will check. I'll check.

DR SCOTT: I would think there are examples, but insofar as you are talking about transparency, both those areas may become relevant when we get to examining the witnesses.

MR HOWARD: Yes.

I think, just on that, it's just important to be clear. The RRPs are obviously public documents, and intended to be public documents. The RRPs are important to the manufacturers in that the manufacturers have to determine what the average selling price will be, and they have to account for the tax to the Revenue on that basis. Obviously, they are in effect acting as a revenue collecting agent in the same way as anybody does, say, collecting VAT. But obviously if they, for instance, pitched the RRP too high, then they will end up accounting for tax which actually they will have to bear out of their own pocket.

So one has to realise and remember it's a very important exercise setting the RRP, that you can't just, as it were, say, "Well, what I am going to do is sell low, pitch the RRP high, then knowing actually that the retailers, because I've assumed a 25 per cent margin for the purpose of the RRPs, will sell at a 5 per cent margin, and so it will, as it were, wrong-foot my rival." In theory one could see that you could do that, but the net effect would be that you were accounting for

an enormous amount of tax. So it's a very important exercise.

I think the discussion we had yesterday, there is a danger of misunderstanding how things work. From the RRP at that stage, you can reasonably infer -- I don't say you can precisely infer -- the wholesale price, because each of the manufacturers, in order to determine the RRP, has to have a view which he will have gained from experience from dealing with the retailers over the years, what the margin requirements are. So there is, as it were, a lot of intelligence about how this works just from market understanding.

Equally you will know what are the volume discounts, and you will also know, for instance, that the supermarkets expect to sell below RRP and that (a) they obviously get a volume discount which enables them to do that, but they are also pitching for the manufacturers to support them in doing that. But again, market intelligence will allow you to know where they are.

Insofar as you get wrongfooted at one stage so that you believe, for instance, that Sainsbury's and its like are aiming to be 10p below RRP, and that they get there through volume discounts and through each of the manufacturers supporting them in that, when you then see that a brand which you were expecting to be at

a particular price is way below, you can infer from that the reason it is below where you are expecting is because it's from price support. In other words, from a further discount.

So that is why you can work out that essentially a special price discount is being offered, and there is a fair amount just through -- obviously you will want to ask the witnesses about it, and I am really just speaking from my reading the papers, but if one just thinks about it for a moment, there is an awful lot you can deduce.

If one says: could you be absolutely certain, the answer is no. But of course that's where all these arrangements allow the supermarkets or the retailer to play people off against each other, and that's what Tesco's evidence actually was, for instance. If they say, "Well, when somebody comes along and sees that we have Benson & Hedges at a low price, that may actually be because they are just trying it on, so that they can then say to Imperial: well, if you want Imperial below that, you will have to pay me, leading to the inference that I have been paid by Gallaher", when they may not have been. The thing is you don't actually know, and that's of course how competition works in any discussion between supplier and retailer, and that's how it should work.

THE CHAIRMAN: I think all we are saying is that if it's part of your case that people reverse engineer from the RRP certain other facts, then it might be helpful for us to know how the RRP is arrived at in order to see what you can reasonably reverse engineer.

MR HOWARD: We will certainly look at that, but I think the point I am making to you is all I am saying actually is something which is really a matter of common sense. It's actually not something that's absolutely peculiar to -- the peculiarity of the tobacco industry of course is that you have these published RRPs for everything. One would imagine in any product where you are selling X to Tesco and you know your rival is selling their competing product, and you see what price it is in Tesco's store, you try to infer from what's going on what the wholesale price was in order that you can try and undercut it. That's what a manufacturer will try and do.

Of course, it may be that the wholesale price of one product is no greater or no less than the other and it's the difference in margin, but that's all part -- what we are looking at is what Imperial's understanding is, and Imperial's understanding generally would be that where they have managed to set their RRP lower, it's because

they correspondingly have a lower wholesale price.

Again, the margins are not necessarily the same across the board for the products, I am sure you understand that, because the reason you will have a different margin, it depends on the nature -- the retailer has a different margin -- of the product. So the products that sell more, there may be a lower margin, whereas the old type of cigarettes which are no longer so popular today which you have seen are not particularly promoted, the ones with high tar, without filters and so on, those presumably have a higher margin because if you are going to give them shelf space, you sell less of them and you need a higher margin.

Those are points really for the evidence.

DR SCOTT: Indeed. Thank you.

MR HOWARD: I hope that's helpful.

If we can go back to what we were looking at on the theory of harm. If I can not recap but remind you, what we are examining at the moment is the basis of the theory of harm and the theory of harm and the main way in which the case is put by the OFT is this lock-step mechanism. We then see how they seek to relax that. But it's very important to understand that the theory of harm in the model is based on this, because what we say is once you relax it, you are actually talking about

a totally different type of relationship, and we say you can't apply the theory of harm and just say "Oh, well, it somehow still applies to what is a very different arrangement".

If you would kindly take core 6, and I am going to refrain from reading out chunks of the report, because of time, but an important passage in Professor Shaffer's report at tab 65 -- this is his 2010 report -- is at paragraphs 91 to 92. This is actually the key to Professor Shaffer's theory of harm. {C6/65/91}

Just before I invite you to read that and remind yourselves of it, if I can remind you what we are dealing with at the moment, in this part of the analysis, is the OFT's case that there are fixed differentials. So their case on fixed differentials is that whenever one manufacturer puts up his price, there has to be a corresponding increase in the price of the other manufacturer's product, and conversely whenever one manufacturer puts down his price, there has to be a corresponding decrease. In other words, the rigidity assumption.

There is then, their case, they say well, even if it's maxima, they then say the rigidity point still applies but it's only relevant in two instances subject to the parallel and symmetrical point where they say

that effectively gets you back to the fixed point. But in order not to confuse things, I am focusing on the fixed point at the moment, but the critical point really is not for present purposes the distinction between fixed and maxima, but the rigidity assumption.

So if you would just remind yourselves of paragraphs 91 and 92.

(Pause)

This is Professor Shaffer setting out his lock-step mechanism, everything goes up and down in an absolutely fixed relationship, and therefore the theory is there is no point ever reducing prices if you are Gallaher because you won't get the market share gain that you are looking for, and there is every incentive to increase price because it won't create any greater loss to you than you currently face, and equally from Imperial's point of view, you can put up the price confident that you won't thereby be out of line with Gallaher because they will go up correspondingly.

So this theory of harm relies -- and he describes it, as you can see, as co-ordination -- on the existence of a mechanism under which vertical relations between manufacturers and retailers perform the task of co-ordinating interbrand price competition.

Now, if we just see what the OFT says, where there are maxima, just to pick up on that, it's dealt with at paragraphs 6.232 to 237 of the decision. Again, I won't read out a chunk of it, but what essentially it is saying is, at the last sentence of 232:

"A maximum differential requirement imposes as a corollary a minimum retail price on brand Y relative to the retail price of brand X.

"So by analogy with the scenarios above, a maximum differential requirement is capable of giving rise to significantly increased certainty. When the retail price of brand X is priced at the relative price ceiling in relation to the retail price of brand Y, any increase in the retail price of brand X would be matched by a corresponding increase in the price of brand Y."

They therefore explain their case on the effect of incentives. Again, this is looking at a rigid relationship and the assumption is that the RMSs require this to happen.

Going back to Professor Shaffer for a moment, and he too considers this alternative version, namely that there are maxima, and at paragraph 120, it starts at paragraph 117, where he considers maximum differential requirements, and at 120, {C6/65 paragraph 120} we see he says:

"The analysis in this case proceeds along similar

lines of the corresponding one with parity and fixed differential requirements with one key difference. Unlike in this case, with maximum differential requirements ... retail prices need not move in lock-step, instead [they] would have the effect of constraining retailer Z's independent pricing of each of its products in only one direction."

Then if you go to 123:

"It follows that there are effectively only two constraints on the retailer's ability to set retail prices that need to be considered in this case. One constraint is that at initially equal prices, retailer Z cannot increase the price of product A1 at its stores without also increasing the price it sets on product B1. With an equal increase in the prices of both products, consumers who would have switched to product B1 if only product A1's price had increased now will not switch. Sales of product A1 would thus be higher as a result of the maximum differential requirement on retailer Z than they would have been otherwise.

"The other constraint to consider is that, at initially equal prices, retailer Z cannot decrease the price of product B1 without also decreasing the price of product A1."

So then he sets out his implications for the

requirements of manufacturers.

Now, again, it's absolutely clear what Professor Shaffer is saying is that where there is a fixed differential, fixed in parity, that's what he calls lock-step. Where you have maxima, it is in effect a lock-step but operating only in two of the situations rather than all four, and his theory is all based upon the effect on manufacturers.

So the question then, having seen that, before we come to consider the variants, is: what is the basis for this assumption of rigidity? Because if that goes, then a large part of this theory of harm goes.

Now, of course one of -- not the only, but one of -- the major reasons that you see completely diametrically opposed views by the experts is because of their different understanding of these facts, and indeed the OFT says the real issue in dispute is whether or not they had established the existence of the infringing agreements. That way of putting it of course rather begs the question, not least because they call them the infringing agreements, and the critical aspect is actually: what is it that you are saying is the aspect of the infringing agreements? At this stage it's perfectly clear it's the rigidity which is the key aspect.

Now, the way in which I propose to deal with this, briefly, although we have looked at it before, is to consider the four different constraints which are said to operate. So the first circumstance is Gallaher puts up its price, a Gallaher price increase. What is being alleged is that, whenever Gallaher's price goes up, Imperial required the retailers to increase the retail price of its product, and that was something that automatically followed a wholesale price increase by Gallaher.

Now, this point, just again one sometimes loses sight, only arises if the OFT is right on a prior point, which is that the differentials are fixed. It doesn't relate to maxima. It's the fixed point. That's what you just saw in Professor Shaffer.

Now, we have already made the point there is absolutely nothing in the trading agreements that required this, ie a requirement that Imperial's price must go up, because they are not fixed, and -- I mean, that's actually the first key point, they are not fixed, but in any event they were incentives.

As we discussed yesterday, in some cases the opposite is actually true of what is being alleged by the OFT, which is that following a wholesale price increase by Gallaher -- sorry, it's not what we were discussing yesterday. The thing is, where there is a wholesale price increase by Gallaher, the trading agreements in fact provided -- no, sorry, in some cases -- an incentive to the retailers not to increase the retail price of Imperial. You remember that in the Sainsbury's and Morrisons example that the bonuses were dependent upon maintaining the shelf prices, absent a Budget increase or an MPI.

So the mere fact that Gallaher puts up its price, actually, if you try, retailer, to put up your price, you will actually lose your bonus. So rather than being encouraged to put up the price, you are being discouraged. So it's the exact opposite.

Even where that term wasn't present, if the retailer chooses to put up its price because -- I am sorry.

DR SCOTT: Yes. What you are saying, this is just looking at the Imperial trading agreements, but ignoring any other trading agreements, so we are at the assumption stage that we are just looking at Imperial, we are keeping out of mind the existence of any parallel or similar arrangement now?

MR HOWARD: At this stage, yes, absolutely.

DR SCOTT: So we are thinking simply --

MR HOWARD: You have to remember that the reason you should really be putting out of your mind this parallel and

symmetrical point, there are a whole series of reasons why, not least it is no longer essentially being argued by the OFT. They are saying "We don't say parallel and symmetrical, we say similar". Similar is very, very different in saying that gives rise to knowledge in general terms. That's not parallel and symmetrical.

THE CHAIRMAN: Yes, but what you are saying is, just looking at this, the first of the four possible way that prices shift, this is not one of the two ways which is relevant if they are really maxima, this is one of the four ways which is relevant if they are fixed --

MR HOWARD: If they are maxima, this is on the OFT's case irrelevant unless they establish parallel and symmetrical. Because without parallel and symmetrical, the point doesn't work.

DR SCOTT: Well, or sufficiently similar.

THE CHAIRMAN: Well, parallel and symmetrical is another way of making them fixed if they are not actually fixed --

MR HOWARD: Exactly.

THE CHAIRMAN: -- in relation to the --

MR HOWARD: That's right.

THE CHAIRMAN: By the terms of the Imperial agreement --

MR HOWARD: Sufficiently similar, I am afraid I don't think does work.

One has to be precise about this. Either something

is symmetrical or it isn't. If it isn't, it is inconsistent, it's quite difficult to really see, but even once you get to -- even if you say there is something parallel and symmetrical, you have to remember then you are actually dealing with a further complication which is you have to then establish that both the manufacturers are actually aware of what the other is doing. Of course, one of the points you will be aware of is you are not going to hear any evidence from Gallaher, the OFT, they have done a deal with Gallaher, but they are not calling any evidence, so we will not have an opportunity to examine what actually Gallaher knew.

So you will be deprived, we are deprived of the opportunity to investigate that, and you simply don't know, the OFT is not seeking to call any evidence on that. So that's a further reason why the parallel and symmetrical point we say simply cannot properly arise in this case.

DR SCOTT: And in any event what you have also just said is that the arrangements may well have been inconsistent.

MR HOWARD: Yes, that's right. Parallel and symmetrical, you can keep saying in the decision parallel and symmetrical, but you actually have to prove it, so when they actually come to prove it, what you will see in the

decision is they hardly put forward anything. They make the allegation but actually they refer, I think, to some correspondence from Co-op and from Shell. They now accept there was not any parallel and symmetrical with Co-ops, so I think you have -- how many letters is it from Shell they are referring to? I can't remember, but a tiny number.

So they then have sought to embroider the case in the defence, which we say in fact they are not entitled to do, but where they get to in the defence is they actually say parallel and symmetrical is not a necessary part of the finding of infringement by object. That's their defence, paragraph 277. So I think that it is fair for me to approach the case by looking at Imperial's agreements on their own terms and the relationship between Imperial and the retailers in order that you can assess whether a case by object is made out.

I agree that insofar as there is something then left where, if they were seeking to bolster it, but the only way as I see it that they are seeking to bolster it, the only way that parallel and symmetrical comes into this analysis is that at this stage in relation to the Gallaher price increase if they fail on fixed, they say "Well, I can get to the same route by parallel and symmetrical", but my short answer to this at this stage is: no, you can't, because you yourself are saying it's not parallel and symmetrical, it's similar, and that doesn't work. Once you acknowledge, similarity is not the same, and that's what parallel and symmetrical requires. Or at least it requires equal and opposite.

If we come back to their case, we have seen the trading agreements, I've explained to you why it's actually counterintuitive to think that Imperial wanted its prices to go up when Gallaher's wanted to go up, and the only answer to that is essentially to say: well, actually, contrary to everything we see in the documents, there is a conspiracy going on here whereby, although you appear to be wanting to undercut Gallaher and to go for -- get your product at lower prices, in truth what are trying to do is to drive up prices, so whenever Gallaher's price goes up you want to put up your price.

The thing is, what you have to remember, again you have to separate out different things. It may be perfectly true that when Gallaher puts up its price Imperial puts up its wholesale price, which results in the retailer putting up its price. That may be perfectly true, but that's not the complaint. The complaint is even though you are not putting up your

wholesale price, the retailer is putting up the price because that's what these arrangements require.

It's a very, very different thing, and that's what this case a lot of the time gets confused with, not recognising that it's not at all surprising that a manufacturer, seeing his rival putting up his price, may do the same, (a) because he may be subject to the same factors, namely the budget increase, the cost of tobacco, the cost of employment; or because he himself thinks, "This is a chance for me to increase my margin if my competitor is doing the same", and that's again how markets work.

THE CHAIRMAN: When there are only two players.

MR HOWARD: Of course.

THE CHAIRMAN: It's an oligopolistic market effectively and that's how it tends to work.

MR HOWARD: That's right, but all of that is entirely different to what this case is about. Really at the heart of all of this, that's what one has to remember, there are other things, and the fact that the manufacturers may, one manufacturer puts up the price and the other one follows, that has nothing to do with the RMSs.

Now, you are going to hear, and I am not going to go to it now, about the -- you have seen it in the

papers -- June 2002 incident, and you have both parties saying, "Look, this shows I am right about all of this".

You will have to come to a view as to whether it actually makes much difference either way. What we say is it certainly does not support the idea that there is a fixed relationship which is the OFT's case; what it shows is that in that instance, what's interesting about it is where Imperial has not implemented a price increase following Gallaher, it wants the differentials to widen. So it shows that the, although very often it may, and people may think it will, that they will be increasing prices at more or less the same time, where they chose not to, what they expected was, and they told the retailers "We actually want our differentials to widen", in other words a competitive advantage.

What the OFT seeks to say is "Well, you wouldn't have -- why did you write those letters?" The letters make perfect sense in the sense that what one is saying is "I want to increase my differential, widen the differential", it doesn't follow that if you, absent the letter, that there was some obligation to increase the price. They are addressing something different.

Now, what is it that the OFT relies on at this stage in support of its case? I am going to take you -- I accept that they rely on other documents at different

stages -- to the documents that they rely on in their skeleton argument, because I think it's fair to infer that they put forward that those documents represent the high water point of their case.

You will see if you go to paragraph 40 of their skeleton argument, under each of the constraints they footnote various documents. You see footnotes 41, 42, 43 and 44. We are currently dealing with constraint A:

"If the retail price of Gallaher's brand increases, then the retail price of ITL's private brand must also increase."

So for that purpose they say: See, for example, at footnote 41, this document.

I think there are three documents. You see there is one, a Morrisons one, an Asda one and a TM Retail one.

Could I ask you, when you look at these documents, to remember what it is we are looking at them for, and that's true of all the correspondence in this case. You have to keep in your mind at each stage: why are you showing me this, OFT, what is it supposed to support? It's supposed to support a case that there was a fixed relationship and that the retailer was obliged to move Imperial's price up when Gallaher's price had gone up, notwithstanding that Imperial hadn't changed the wholesale price of its product. So that's what they are seeking to say. When you look at the correspondence, you will see it doesn't support that at all.

So the first one is in SO annex 17, document 16, {D17/16} and you ought to keep open probably the skeleton, because it's in relation to a lot of these you need to -- you will just note, not necessarily a matter of criticism because obviously you can't set out everything, but the excerpts that are set out don't properly explain to you what actually the correspondence is about. So if you can see:

"You are probably aware that the broad marketplace has moved from 3.29, 3.30 to 3.34, 3.35 on Dorchester, and Dorchester Superkings.

"You may remember from my presentation on Richmond repositioning and the launch of Richmond Superkings that our strategy is parity with Dorchester. In the light of this, we are moving Richmond up to the price you can see. In order to maintain your cash margin position, the bonus levels at [that price] should be as follows."

What is important to note in the OFT's skeleton is that they miss out that line, and then they miss out what follows. What is happening here is that Imperial is moving up its price on its product, Richmond, following the end of a Gallaher promotion on Dorchester. Imperial is ending its temporary promotion on Richmond,

so that what you have here are price and bonus figures showing that prices are going up because the tactical bonus is being withdrawn. In other words, this is not evidence that Gallaher's price increase must per se also result in a price increase of Imperial's product; this is Imperial simply saying "We are withdrawing now the bonus, the tactical bonus because we no longer wish to be supporting, providing a tactical bonus to try and meet what Gallaher are doing, because Gallaher are no longer price cutting on their brand, Dorchester".

DR SCOTT: Sorry to interrupt you, it's just so that we know this for the future when we read back, just before we went to this document you were talking about June 2002, and I realise that we are now in November 2000.

MR HOWARD: Sorry, I was talking about June 2002 in what context?

DR SCOTT: You talked about "the June 2002 incident".

MR HOWARD: No, that is a different incident --

DR SCOTT: It is just so that we get into the transcript that we are now in November 2000.

MR HOWARD: Thank you, sir, I apologise. There is a danger, obviously I am slightly tight for time, and if I misspeak or take things too quickly, I apologise.

The June 2002 episode I was referring to in very short terms because there is a debate about what that

shows. We are now on paragraph 40 of the Office of Fair Trading's written skeleton, and the documents that they refer you to as examples to support their case that there was a fixed relationship with a requirement that if Gallaher's price went up, Imperial's price had to go up.

This letter is the first one they refer to, and when properly analysed, indeed when you set out the full text of the letter, it's actually perfectly clear that it is not dealing with any obligation to put up the price because Gallaher has put up the price, it's withdrawal of a price promotion as a result of which the retail price is expected to go up.

The words that are important in the letter are:

"In order to maintain your cash margin position."

In other words, it is understood you are seeking to earn this margin, in order to earn the margin that we understand -- and of course this is the price that you will need to price at, because you have got your bonus, the ongoing bonus, but what we were previously paying you has gone, and so this is what you will need to do in order to maintain your margins.

The thing is, what the letter is not saying is, when viewed correctly, because Gallaher's price has gone up, you must independently put up our price. What it's

actually saying is effectively we are putting up our price because we are withdrawing our bonus, and therefore in order for you to maintain your cash margin, this is the price you will now need to charge.

That's that one. That's the first letter. The second one is in SO annex 14, it's the Asda annex, document 30 {D14/30}:

"Again, following yesterday's increase in the retail price of Amber Leaf, I would like to increase the retail prices of ITL's range as follows."

THE CHAIRMAN: Just remind us who the author of this is?

MR HOWARD: So this is Martin Downham of ITL. You can see it at the top left-hand corner. Amber Leaf is a Gallaher product, and it's a roll-your-own, in the vernacular, and one sees:

"I would like to increase the retail prices of ITL's roll-your-own range as follows."

So they are saying they want to increase the retail price of Drum and Golden Virginia.

"These prices will be achieved by withdrawing the bonus support", and of course you will see that ... (Pause).

In the skeleton, they seem to quote from another letter. They quote from that letter, and they appear to quote from another one. I am not sure which one that is.

Taking this letter, it's perfectly clear, on the face of the letter, on the face of the email, what is happening, which is withdrawal of bonus support. So what they are saying is -- and that's because there have been promotions on Amber Leaf, and they were promoting Drum and Golden Virginia to try and match Gallaher's promotion, having seen the Gallaher's promotion came to an end, they decided to withdraw their promotion, so were saying this is the effect.

Again, you have to remember, it has nothing to do with what is being alleged. That's the thing. They are alleging -- I can't say this too often -- that there was an obligation on the retailer where the Gallaher price went up to move the Imperial price. Well, one of the things: if there was, why are you writing the letter? Self-evidently there wasn't. What they are saying is now I am withdrawing my bonus support, that will result in the price being changed because that's again, based upon what they understand are the margins in this case that Asda are seeking.

This email is dealt with by John Jolliff, the witness for Asda, whose statement is at core 10 -- I don't think we need to get it out -- tab 109 at paragraph 91 {C10/109 paragraph 91} and indeed he there

said that it was an email confirming the end of a period of promotional funding on roll-your-own tobacco, and he explains that the effect of the bonus support being withdrawn had the effect of increasing his net cost price, and so he would have to move the prices to those indicated in order to maintain his margin.

MR SUMMERS: Mr Howard, I am sorry. The prices shown here, are they simply restoring the price levels to those which existed before the promotion started, or are these setting new higher levels of prices and not reverting to the previous prices?

MR HOWARD: My understanding is that they are reverting to the previous price before the promotion.

DR SCOTT: Just one other question, Mr Howard, about the status of this document. On the face of the document, this is a draft, which is faxed to somebody, and contains that "Please check this will fill the gap before I send it". Is it accepted that it was ever sent?

MR HOWARD: Yes.

DR SCOTT: That's the next tab? Okay.

MR HOWARD: Yes. It is accepted. Just to answer that point, we will obviously have to check, my understanding is firstly that it is going back to the previous price, but secondly, even if it's not, it doesn't actually

affect the analysis, in the sense that what -- well, again what one is looking for is evidence that the retailers were required because Gallaher has put up its price to move the price of Imperial, and that being as a result of the RMS arrangements. What this is showing is simply, we are withdrawing the bonus support, and this is the price in the light of that, and which the witnesses explained, Mr Jolliff explains, that this is in order for him to get the margin that he is looking for. As I say, my understanding is it is in fact going back to the prior price.

MR SUMMERS: But it could go to the point you were making that price increases may occur where there is not necessarily a manufacturer price increase.

MR HOWARD: This is a manufacturer's price increase in the sense that when --

MR SUMMERS: It's a withdrawal of bonus, isn't it?

MR HOWARD: I think to answer your question, a withdrawal of a bonus is in fact a price increase, firstly, in the sense that when you -- I mean, the problem is we are just playing with words. When you provide a bonus, what you are actually doing is reducing the wholesale price. When you withdraw it, you are putting it back up again. It may be that it's back to where it was before. But equally what I can't tell you at the moment, we can look

into it, whether Gallaher at this time was both withdrawing the bonus and putting up the price. In other words, you can have both and therefore if the price is higher than it was before, that's because in fact there has been a manufacturing price increase as well as the withdrawal of the bonus. I don't think that's what was happening but I am just saying that the two can happen at the same time.

As I say, what on its face the document is saying and what the evidence of the witness is saying, Mr Jolliff, who received this, is it's exactly as I described it. What is it you might think is very, very curious in the OFT's case, they continue to assert that this is evidence of this arrangement notwithstanding that. It's actually quite difficult to understand. What is their case on that? They have not, as I understand it, interviewed Mr Jolliff to ask him about that. One would have thought you would have done, to find out.

But in any event, on the face of the document, it doesn't support what they are saying.

Now, the final document that they put forward in support of this part of their case you will find in SO annex 22. {D22}

The bit that is relied on is under the first paragraph which is headed "Richmond SA, Kingsize and Superkings 20s":

"From 8 November we agreed to raise the retail price of Richmond Kingsize ... by 10p per pack. This applies to all tiers, and I will update the promotional schedule adjusting the selling price and bonus rates and forward a copy. I understand this move in price will be in line with competing brands. Please let me know should this position change."

So what one has here is an email which relates to the end of short-term promotion whereby ITL, Imperial, had been funding lower prices for its Richmond brands, following a manufacturing price increase which had taken place on 3 September of that year, so a month or so prior.

The context is actually set out in an earlier letter in this bundle at tab 14, which was, you can see, providing for a promotion.

Document 16 confirms that the promotion supporting the flat price of £3.39, and £3.40, which you can see on page 87, tab 14, was to end from 8 November, and therefore if TM Retail didn't wish to continue to fund the promotion itself, it would need to increase the prices to the levels identified. It's not saying because Gallaher have put up the price, you must do

this. What they actually are saying is they understand that Gallaher is ending a price promotion of its own, and therefore this price will be in line with competing brands, let me know if this position should change.

There is no expectation that because Gallaher is putting up its price you must put up ours. They are ending a promotion because they don't think it's necessary, but actually if they find they are out of line, then they might put the promotion back in. Again, it has absolutely nothing to do with the so-called rigid requirement of putting up prices.

So that's dealing with those three examples. Then I am going to deal with the examples -- because again these are dependent upon the fixed relationship -- in C:

"If the retail price of ITL's brand decreases, then the retail price of Gallaher's rival price must also decrease."

Again, I should have reminded you on the first, in relation to the fixed point, of course there is the empirical evidence which I showed you yesterday which shows there isn't this fixed relationship, also of course the evidence that there is no requirement in the way that the OFT has put it. But it is again bizarre to suggest that if ITL -- just think about it for a moment -- puts down its price, that ITL wants the

retailer independent of what Gallaher does to put down Gallaher's price. I mean, I don't know what competition world those in the OFT who thought of this have come from, but it just does not make any sense at all. Why ever would a manufacturer want to cut its price and expect the retailer independently to put down the price of its rival's product? What he actually does when he cuts his price, he holds his breath and crosses his fingers and hopes that the other manufacturer won't follow them so he can gain market share. His irritation is when the other manufacturer decides to try and match him, but that's how competition works. So it's a nonsensical case.

Now, what are the documents that they rely on in support of this? There are two at this stage. They are a Safeway document and a T&S Stores document. The Safeway document is in annex 28, and it's at tab 38. {D28/38} Take this one quite quickly. Again, you see this is selective quotation from a document, so you don't correctly understand it. What you can see is the introduction about pricing:

"Following our meeting this week, I set out below the prices in Safeway which are wrong or require further investigation."

What the OFT has quoted is the last, the penultimate

paragraph:

"There should be one price for all cigars and noting your main competitors, I suggest the following levels."

It has nothing to do with an Imperial price decrease, it is in fact, as Safeway have explained, and they are probably the best people to deal with it, that in the Safeway stores -- basically what was going on was that Safeway, were not, as it was perceived, correctly pricing the products in accordance with their own pricing strategy. In other words, there was incompetence within Safeway, and Imperial spotted this and were reporting to them that the Safeway pricing policy was not being implemented properly, as they understood it, and that's what they were telling them. That's why it says:

"I set out below the prices in Safeway which are wrong or require further investigation."

If Imperial understand that they are intending to have one price for all cigars, and they have got different prices, there is nothing wrong with pointing that out to them. But whether or not one thinks otherwise, and I would suggest there isn't any basis to think otherwise, this has nothing whatsoever to do with what we are addressing, which is again it's said because Imperial decreased its price, there was an obligation to decrease the price of the competitor's product, notwithstanding that the competitor was not doing so. Completely nonsensical allegation and a document that doesn't support it.

Then you come to the final one, T&S Stores, which you will have in annex 29 at document 19. {D29/19}.

This one is in the decision, and the footnote cross-refers to paragraph 6.1521 of the decision. It's very important to actually see what it's about, which is Day & Nite stores.

This is all explained in the witness statement of Mr Culham, who explains that what had happened was T&S had purchased Day & Nite stores in the year 2000, and they were intending to bring those stores within their pricing structure, within their pricing tiers, and that pricing structure had tiers and a strategy setting shelf price levels at certain levels below or above RRP, and T&S had discussed that with Imperial, as they wanted to make sure that they could get the same bonus arrangements on Day & Nite as on their T&S stores, and what in an earlier letter Mr Culham had done was to indicate the funding which would be available, and in this letter, all he was doing was working out the bonuses that were available.

Probably because of the time available, it's best to

leave you to read what Mr Culham says in core 3, tab 35 at paragraphs 122 to 124, {C3/35 paragraph 122} but you can see from this letter that it is a fairly detailed letter, and once one understands the background, it has absolutely nothing whatsoever to do with the allegation that's being made.

DR SCOTT: It does employ the word "differential":

"From the visit we have now noticed the following differential errors."

MR HOWARD: Exactly, but the differential errors that are being referred to here -- you have to remember, again you have to be clear what it is that's being alleged. This is a letter which is supposed to support a case that whenever there is an Imperial price reduction there is required to be a Gallaher price reduction. So it's not actually about that at all. So yes, what was happening was Imperial monitor the stores. Here the particular background was looking, investigating the extent to which Day & Nite stores were pricing in accordance with what Imperial understood T&S were trying to do, i.e. their retail strategy, including their retail strategy of intending to earn the bonus which was on offer. So yes, there is a reference to the differentials, and asking them to correct them. Because their understanding is that T&S are intending to have

the differentials.

Again, as I say, I can't underemphasise the importance of actually keeping in one's mind what it is that the correspondence doesn't show, which is in relation to the case.

So the whole basis of there being -- these are the best examples in relation to constraints A and C, one has to wonder really why we are all here.

Now, one then comes to the other two constraints, which are where, as you can see:

"If the retail price of ITL's brand increases then the retail price of Gallaher's brand must increase, and if the retail price of Gallaher's brand decreases, then the retail price of ITL's brand must decrease."

Our position is that the RMSs were designed to incentivise on the basis of maxima. Accordingly, they could not impose restrictions -- we say they didn't impose restrictions, but they certainly couldn't do it where Imperial decreased price or Gallaher increased price. Such restrictions would be contrary to the stated objective of trying to win market share.

Now, if we consider these two constraints now, **constraint B:** according to the OFT, constraint B is the central part of its case. That's what they say. Could I ask you to take core 4, which is where we will find

their defence, at tab 46, if you see at page 166 of the bundle, paragraph 35, {C4/46/166} second sentence they say:

"ITL ignores the central part of the OFT's explanation of the anticompetitive nature of the infringing agreements."

So it's the central part, and that's a cross-reference then to paragraph 6.216, and the central part of the case. Therefore, it is worth looking at that:

"If manufacturer A has a requirement that a retailer's price for brand X is linked to the retail price of competing brand Y, by virtue of the required parity or fixed differential, that requirement is capable of giving rise to a significant degree of uncertainty that competing linked brands will move in parallel, and the loss of sales that you would normally expect to suffer by increasing your price is significantly reduced. As a result, manufacturer A would enjoy the gain in revenue from increasing its wholesale price without suffering the loss of sales that would normally result."

So that's the central part, and at paragraph 38, you can see about five lines down, that's described as the central component of the OFT's theory of harm, and also they cross-refer here, over at paragraphs 36 and 38, to Professor Shaffer's report. So no question that they are pinning their colours to the mast as established by Professor Shaffer.

Now, if one then considers this for a moment, we have already looked at two of the trading agreements. None of the trading agreements provide for, were Imperial putting up the price, that there is a requirement to put up the price of Gallaher's product. None of them in terms contain such an obligation.

What you have to distinguish in relation to this is, one, if Imperial puts up the price that Gallaher puts up its price, that's one thing, and the retailer then putting up the price of Gallaher because Gallaher's wholesale price has gone up. That's not what we are talking about. The other is the retailer putting up the price of Gallaher, even though Gallaher is not putting up its price, and that's what this theory of harm is, because it's the manufacturer can put up -- here Imperial -- the price of its product in the knowledge that the price of Gallaher's product goes up, whether or not Gallaher is itself seeking to put up the price.

Now, as I say, and you have to distinguish these two different things.

If Imperial put up the price, and Gallaher chose not

to respond with its own wholesale price increase, all that would then happen is that the RMS differentials in the trading agreements would simply adjust as a result. The retailers would still be entitled to qualify for the RMS incentive payments, but on the basis of altered differentials.

DR SCOTT: Sorry, you have me a little confused there. Are you saying that the differentials in the prices would change, which I understand, or that the differentials in the agreement would change? Because we recognise that sometimes, you know, a fresh schedule might be issued.

MR HOWARD: If you issue a fresh schedule, then that's the thing, you can always issue a fresh schedule, so if you put -- but what we are looking at is a situation where you have not expressly issued a schedule, what actually then was expected to happen.

Part of the problem with this is that we are debating something which doesn't have any relationship to real life, because in real life, what actually happened was that when Imperial put up its wholesale prices, not necessarily the same day, but within a short period, usually Gallaher would do the same. That has nothing to do with the RMSs, it's simply that when one manufacturer was observing what the other was doing, it might react. Occasionally, for instance we saw when

Imperial chose to hold prices, that didn't happen. But generally that did.

What one doesn't have is instances of the manufacturer, here Imperial, putting up its price and it requiring -- and that's what is being said in evidence -- the retailer and saying to the retailer "We have put up our price, why haven't you put up Gallaher's price?"

We will see what correspondence is relied on for this, but before we look at the correspondence, the trading agreements don't on their face say that and this is where the whole thing about this being contrary to the interests of the retailers come in, because it's one thing if the retailer says "Well, okay, Imperial, I can't stop you, you are putting up your wholesale price, the result of that is I will need to, want to sell your products for more", but it would make no sense at all for the retailer to say "As a result of that, I am going to put up the price independently of Gallaher", although you can say: ah, wouldn't the retailer be obliged to do that? He might try and do that because it's in his interest, but he won't want to be obliged to do it. Why? Because he may then find himself out of kilter with Tesco or whoever else it is. He could only enter into such an arrangement if he has

complete confidence that the whole of the market is going to do exactly the same. Since we know it is the case that the party with a market share in the supermarket sector of in excess of 30 per cent was not said to be party to this, it's rather difficult to see how this would work.

None of the witness evidence supports the case, and indeed the OFT, you remember they are only calling one witness, that witness says the opposite to what the OFT's case is. So it is again necessary to look at what she says. It's in core 6, tab 69, pages 438 to 439, {C6/69/438} paragraph 55 is entirely contrary to the OFT's case.

She says:

"The Price Relatives/Differentials.

"It was their ideal strategy to have price relativities probably for 99% of the time those relativities were in place, but there would be the odd couple of weeks between MPIs where they would be out of parity. If, say, Imperial had an MPI and they were the first one to go and they put Marlboro up 5p, I would not stick Benson & Hedges up 5p if Gallaher had not announced a price increase, even though Imperial 's strategy was to have parity between Marlboro and Benson & Hedges. It was Imperial 's decision to go first and they would expect somebody to follow them .

"They would not come to me and say 'Gallaher have not had a price increase but we expect you to increase all their shelf prices'. If Gallaher or Rothmans did not follow Imperial 's MPI, imperial would have to reduce its own prices to realign the price differential -- but it would be up to Imperial to do so."

In other words exactly the opposite of what the Office of Fair Trading's case is. It's if one manufacturer puts up its price, it hopes that it won't find itself out of line, it hopes that Gallaher will follow suit. If that hope proves to be frustrated because Gallaher is taking a robust approach to whatever it was that motivated the price increase, then it has to, with its tail between its legs, come back and reverse the thing.

Actually what then happens in fact which supports all of this is -- and I won't take you to it now but I would refer you to the correspondence that we have set out at section 3 of our skeleton argument -- what you find is numerous examples where Imperial announce a price increase but then say to the retailer "Please hold the price of a particular brand" because they are waiting to see what Gallaher do. In other words,

although they announce a price increase, they say don't implement it. So in other words the fact there is a price increase may filter into the market, but what they want to see is whether or not Gallaher is also increasing. If Gallaher doesn't and hasn't for the moment, they don't want to put themselves at a competitive disadvantage. All of that would be completely nonsensical if it were correct, as the OFT asserts, that there was some obligation or anything approaching an obligation that the retailer, independently, should put up the price of the Gallaher product.

So just before we look at what the OFT puts forward in support of this part of the case, one says it's not supported by the terms of the trading agreement, not supported by any economic interest of the retailers, it would be entirely contrary to their interest, not supported by what we have shown happened. So that one then sees in their skeleton they cite, I think, altogether four communications at footnote 42. So this is the central part of the case. Let's see what they have there. So we have First Quench, which is in SO annex 16, and for this purpose we are looking at a letter from Mr Byas, which is at document tab 15. {D16/15} The paragraph of the letter that the Office of

Fair Trading relies on is at the foot of the page:

"With regard to Dorchester and Richmond, we would like to move Richmond up in price to £3.45 as soon as possible. Other accounts are moving in a similar direction, and if you are speaking with Gallaher in the next few days, I should be grateful if you would encourage them to move Dorchester to £3.45 on, say, 18 or 26 June."

What one sees is, in the text, Imperial asking First Quench to encourage Gallaher to change the price of Dorchester. Now, it is plainly not reflecting there being some pre-existing requirement upon the retailer independently to move the price. What it actually shows is that Imperial was uncertain what Gallaher would do. Indeed, if Imperial had a requirement that its price increase should be followed by the retailer putting up the price of Gallaher, one wouldn't need to write this. Nor, if you had an expectation that the retailer would move the price independently of Gallaher, would you write that.

It is fair to say that it's questionable whether Mr Byas of Imperial should have been writing to First Quench in these terms. But that is not what the case is about, again. The allegation of illegitimate indirect contact, in other words the hub and spoke case,

has been withdrawn. The thing is, if you were running a hub and spoke case, you would need to show that this information, firstly that there was inappropriate price information being passed on to -- well, it's not inappropriate price information being passed from Imperial, it's that Imperial is expecting and requiring price information to be passed on to Gallaher. So that's the first thing you would have to test. Then you would have to show that it was in fact passed on, and then you would have to show that it was in fact acted on. In other words, those are the links in the hub and spoke, which, as I understand it, have been established by the Court of Appeal in Argos v JJB. I'm displaying that I'm not the specialist, as everybody knows, in this field, but I have sufficient familiarity with that at least.

This letter, so what one sees is it encouraging Gallaher to do something, as I say, it does not support the case which the OFT is seeking to make out, and you always have to look at it and ask: how does it fit?

The next one is at annex 28, and it's again the Safeway story, not properly looked at in its context. So you see at tab 34 {D28/34}:

"There is still an error in the pricing of both Mayfair and Sovereign in all Safeway stores. The difference between Lambert & Butler and John Player Special should be minus 16 and minus 9 respectively. Currently the differentials are minus 18 and minus 11. Can you please increase the prices of both Mayfair and Sovereign by plus 2p, and then the increase will then make their prices in stores as follows.

"Many thanks, George Byas."

The RRP differentials at that time indicated that ITL's brands were intended to be not more expensive than plus 16p on Lambert & Butler and 9p on JPS, which were the Gallaher competing brands. ITL was saying in the letter that its retail prices were too expensive, as it saw it, in the Safeway stores, relative to Gallaher's competing brands.

The fact that the prices that were so could have been due to an administrative error on the part of Safeway in implementing what they call the tilt in their stores, or it could have been as a result of a deliberate policy on the part of Safeway, or as a result of a Gallaher promotion. What was understood by Imperial, as you can see here, is that they thought there was an error going on, and so in fact the position -- and Safeway deal with this in paragraph 34(a) of their skeleton as well as the places we deal with it -- Safeway did not alter its prices as

a result of this, and you can see that at documents 35 to 39, where the correspondence continues.

That in fact reinforces the point that they were free to set prices as they choose, and that they were pursuing their own pricing policy. The prices for the Gallaher brand remained the same some two months later.

So all one gets out of this is Imperial thought there was a mistake in the way that brands were priced, Safeway, there obviously wasn't, and Safeway therefore continued to price them as they had before. Nothing sinister about it. They thought that the differentials were higher than Safeway was intending, and in fact it appeared that the differentials were what Safeway intended. So again, you have to bear in mind what it is we are addressing, which is it's supposed to be an obligation when Imperial increases its price, then Gallaher's price must be increased. It has nothing to do with that at all.

I think the next two are in annex 22. So we have a document at 16. {D22/16} Actually, we have basically I think seen this before. It's that paragraph under -- you have probably already marked it -- "Richmond Kingsize", and the emphasis seems to be on those words:

"I understand this move in price would be in line with competing brands."

I have already explained what it related to, the end of a short-term promotion. What it shows is in fact, contrary entirely to the OFT's case, uncertainty regarding the pricing of Dorchester, and inconsistent with any idea of there being an obligation to move the price of Gallaher's product. It's because they anticipate Gallaher has withdrawn its funding, anticipate that therefore the retail price of Gallaher is going up, they are withdrawing their funding for Dorchester and therefore the Dorchester price they anticipate will go up.

DR SCOTT: Just in passing, it's a reference to the future, so this isn't an observation of a price change suggesting that Gallaher have moved, it's a suggestion that they know that Gallaher are moving and there will be a change.

MR HOWARD: Let's just backtrack a little bit, we need to be careful. It has nothing to do with moving Gallaher's price, firstly. You have to remember, that's what we are talking about.

DR SCOTT: No, I understand what you are saying. Yes.

MR HOWARD: Now, secondly, it's saying "We believe, we understand that Gallaher is doing this, therefore we are doing this, but let me know if I am not right". Now, Imperial, we are talking about a vast market, and of

course they are watching avidly, through general market intelligence they learn or believe that Gallaher's ending a price promotion. That's what we are saying, that's what we understand is happening, and that's why we are doing this. We may be right, we may be wrong, and they are saying "Let us know if we are wrong". There is nothing untoward in that, that one manufacturer says: this is what I believe is happening.

Again, whether one says "I wonder whether they are privy to some information that they shouldn't have", it's not this case, that's the thing. The OFT has dropped that, obviously they investigated and came to the conclusion that the evidence didn't stack up, so simply saying, well, you know, there we are, this looks like possibly that they have learnt something, query should they have done, you don't need to worry about that, we need to focus on what it is that the thing is supposed to support, which is a different allegation.

The next one is tab 24, {D22/24} and again the bit that is quoted is the line, penultimate line:

"Superkings, Berkeley, Raffles, B&H, Superkings in tiers 1, 2 and 3 need moving up."

What this is actually about is these people TM Retail have a rather complicated structure and they have various tiers, and basically -- there is no secret about it, you will see it in the documents -- they have a strategy for pricing at different levels in those tiers, and what is being said here is that they appear not to have got the pricing strategy right in that the prices in tiers 1, 2 and 3, of both Imperial and Gallaher brands, don't seem to be correct, is what they are saying in that line.

I think they had 11 tiers, no less, and this is just relating to three tiers, and it's also after the Budget. So you have people who have a very complicated tiered structure, you have whoever was the Chancellor then seeking to gain a bit more money -- I think that was probably Mr Brown, wasn't it? -- fleecing the smokers, and then you have a retailer who is not correctly pricing things, and you have evidence that the manufacturers had a heavy involvement in checking that they were doing it properly, and telling them that you actually seem to have it wrong in your bottom three tiers. Whether it was bottom three or top three doesn't matter, I think it was the bottom three. That's all that this letter is.

THE CHAIRMAN: Is that a convenient moment? Are we now going to move to D?

MR HOWARD: I was going to move to D. That is a convenient moment. Can I say, I am conscious of time. I suspect

you won't be surprised to know that I am a little bit behind. I would ask for your indulgence, and there is a little bit more that I want to say, and then it will be Mr Brealey's turn, but I suspect that it is quite important that I should, on behalf of Imperial, particularly then go on to deal with some further points on the theory of harm. Although, therefore, time may get a bit squeezed, but I suspect it is quite important for the Tribunal and certainly for my clients that I should have the opportunity. So can we see where we get to? But I am conscious that I may be eating a bit into the time.

THE CHAIRMAN: Well, we will come back, then, at 10 to 12.

(11.40 am)

(A short break)

(11.50 am)

MR HOWARD: So we are now considering the constraint where if the retail price of Gallaher's brand decreases, then the allegation that the retail price of ITL's brand must also decrease, paragraph 40(d) of the OFT's skeleton.

This is a point which is contradicted by the trading agreements, the witness evidence, the correspondence. The trading agreements, which we have already considered the point, actually had, in the main, the opportunity to respond clauses, there is no point in having

an opportunity to respond clause if there was already an obligation or requirement on the retailer to reduce the price of Imperial's product to match the reduction in Gallaher. So it's simply difficult to reconcile the two.

Where there wasn't an opportunity to respond clause, the relationship was in fact no different.

Now, the witness evidence called by the OFT, in the form of Ms Fiona Bayley -- core 6 again -- contradicts the case. It's {core 6, tab 69}. Two references, absolutely explicit. Paragraph 7:

"None of the tobacco companies had any say about the level at which I sold other brands. They all had competitor brands against which they sought to benchmark themselves."

So that's the evidence of the OFT, on behalf of the OFT, none of the tobacco companies had any say.

Then paragraph 78 -- we have seen that yesterday -- where she makes it clear that if she implemented a tactical move for a competitor, Imperial would see this and want an opportunity to respond. I wouldn't initiate it. And then she explains it was up to them whether or not they would respond.

So the evidence that the OFT calls is contrary to their own case.

Then there is again a large amount of correspondence which we have cited in section 3 of our written skeleton where Imperial, one sees funding price reductions to match Gallaher price reductions, in fact spending vast sums of money to do that. If there was already a requirement on the retailer to reduce Imperial's price because Gallaher had reduced its price, why was Imperial spending all this money? Doesn't make any sense at all.

Then to turn to the documents, there are loads of documents that we have cited, I am not going to take you to, I am going to take you now to what the OFT obviously sees as the high water mark of its case in two documents, one in the Morrisons SO, annex 17 at tab 60. {D17/60}

Again, very important to see selective quotation from a letter, when you look at the letter properly it is actually saying the opposite to what the OFT is alleging.

What the OFT does is, tab 60, it's the second page, and it's an email from Paul Matthews of ITL to Grant Eastwood of Morrisons, and he says:

"I understand that one of our competitors has decided to reduce the retail selling price of Amber Leaf. Whilst I would prefer to keep more cash in this important subcategory, I need my brands to remain competitive. To this end, I would be grateful if you would bring all Drum SKUs into alignment with all Amber Leaf SKUs."

The OFT stops their quotation at footnote 44 there. So they infer something sinister going on. Therefore you have to read on:

"This will necessitate the following shelf price reductions and increases in bonuses" which are then set out.

So in other words, what that text there makes clear is that what Imperial is doing is responding to a price move by Gallaher, Gallaher has cut the price, Imperial are then paying money to cut the price of their product. So it's the opportunity to respond, whether it's actually not being done by specific reference to a clause, but it's responding to a price cut by your competitor by cutting your own price.

DR SCOTT: Just to be clear about the language here, the RSP is the retail shelf price, so we assume they have left the RRP where it is, they are just reducing the shelf price?

MR HOWARD: I think that's probably right, in the sense that -- I'll have to check. There are two possibilities, one is that RSP and RRP are being used interchangeably. The other is that because it's

a short-term promotion, they have not formally changed the RRP because it has tax consequences, and therefore they are talking about what is the actual shelf price at this time. I am not sure which it is. But it doesn't really matter. The important point of the letter is that what -- the detail, in other words. Obviously we will be able to ask the witnesses and we can look at the detail but that isn't, with respect, what is important. What is important is what you see happening is competition in action. Gallaher have cut the price. The chap is actually saying "We don't really want to do this, but we have to remain competitive, we would rather not spend the money on this, but those dirty dogs Gallaher are putting us in the position and so if we don't do it we are going to lose too many sales". That's how the market works. Poor old Imperial had to spend money, hopefully it worked. It's very difficult, you know, one has to remember what it is that's being alleged. It's being said because Gallaher decreases its price, the retailer a fortiori automatically is under a requirement to reduce the price of Imperial. It's self-evident on this letter that isn't at all either a requirement or an expectation or anything of the sort, it's simply a competitive response by one manufacturer.

So all of that is again borne out by the evidence.

This is what the OFT says supports its case, whereas what you actually have is the entire -- something which is entirely inconsistent and indeed quite the opposite.

You have something which couldn't be, with respect, more pro competition than, when one looks at it from the point of view of the consumers, manufacturers battling it out, price cutting to try and gain sales.

The next one is Somerfield in annex 20, tab 44. {D20/44} It's part of an email chain between Mr Hall of ITL and Mr Thomas of Somerfield.

What's referred to is in the middle of the email on page 330, Mr Hall says:

"Our strategy pricing requirements apply across all price tiers. The strategy is that Richmond Kingsize matches Dorchester and Richmond Superkings matches Dorchester Superkings. That's what I said to Stephen Clarke when he was setting up the post Budget prices."

Then you can see a few lines up that Martin Thomas replies saying again this is all immediately post a Budget, and Mr Hall in his witness statement explains that Gallaher had been funding a post Budget promotion on Dorchester, and he made an offer to match the promotion for ITL's Richmond brands across all the Somerfield price tiers.

In other words, it's again -- in fact, sorry, I should have shown you, this is, if you go to the next page, 331, you can see that that's exactly the position that was being explained, that Gallaher were promoting Dorchester, it's what it says, and Imperial, whether reluctantly or otherwise, decided to match them.

Again, nothing to do with there being some requirement, obligation, or anything of that sort, that the retailers should move the prices; it's all as a result of competition in action.

So in relation to all of this, I've already made the point, how does the case that is made fit in with the retailers' independence and strategies? The OFT here misses the point. Imperial and the other appellants and their experts have said that it does not make any sense for the retailers to have entered into the type of agreement that the OFT alleges. The OFT's answer to that is to say "What's this got to do with the case? They did enter into the agreement, so whether or not it made sense for them to do so doesn't matter". But the question is, you have to decide whether they did enter into the agreements of the type alleged by the OFT. We and the retailers say they didn't, and we say it is entirely against their economic interests for them to have done so, and it is difficult to explain why it is being said and the basis for saying that they entered into it if it was so much against their interests.

Now, I do not want to spend a lot of time at the moment on this, but if I can just explain how this arose. In the decision, the OFT did not consider the question of whether or not the retailers had any incentive to enter into the arrangements of the type they were putting forward.

Mr Ridyard, in his first report, explained that the case that was being made by the OFT was entirely contrary to the interests of the retailers and didn't make any sense for that reason. In particular, he explained that because they were benchmarking themselves in the case of the major supermarkets, particularly a number against Tesco, it doesn't make any sense for them to have curtailed their freedom to benchmark against Tesco and to put themselves into an uncompetitive position. That benchmarking point is explained by a number of the witnesses, including Mr Hall and Mr Batty, and Mr Matthews I think, and Mr Mason of Asda and Mr Eastwood of Morrisons.

Now, in the context of that, there has then been a debate about retailer incentives. What has emerged is this: Professor Shaffer, in his 2007 report, which was his report which the OFT commissioned at the time when

they were preparing their decision, or which they used to support their decision, although it wasn't disclosed as part of the decision, he simply asked himself whether, if there was this fixed parity and differential requirement and if there was this rigid requirement, whether or not that would result, as his simplistic model was purporting to show, in higher prices.

But in order to get to the conclusion that it would make sense for the retailers to enter into any such arrangement, he assumed for the purposes of his 2007 report that the retailers had no bargaining power whatsoever, in other words that Imperial was able to coerce them into entering into agreements which would otherwise be entirely contrary to their interests. That, he acknowledges that he was making that assumption in his 2011 report. It might be worth just turning that up. It's in core 6, tab 66, and if you go to paragraph 4, page 3, footnote 4, {C6/66 paragraph 4} you will see he says:

"Recall that manufacturers are assumed to be able to make take it or leave it offers to retailers in the model."

So the economic model that he puts forward is the manufacturers have all the power and the retailers have none. One would have thought a very simple sense check

might have been employed to ask: hang on, do you really say that Asda has no economic power at all and is just in a position of take it or leave it? Do you really say that's true of Tesco, of Sainsbury's, of Morrisons, Somerfield and Shell? It couldn't be a more nonsensical assumption for both Professor Shaffer and the OFT to be making and to form the basis of the model.

So where does one then go with all of that? What is now said, and one sees this being echoed in this footnote, is an assumption: oh, well, you should -- bargaining power may be more equally split. That also appears at footnote 20 on page 14 of the report. He says:

"The manufacturers are assumed to have all the bargaining power in the model contained in the appendix of my 2007 advisory report. However, even when bargaining power is more evenly distributed such that retailers would need to be compensated to accept P&D requirements from the manufacturers, it does not follow that lump sum payments will necessarily be observed as the manufacturers may have other means of transferring surplus to the retailers. The other means might include retrospective rebates as well as flatter quantity discount schedules and other things."

The problem with all of this, put it very shortly,

you can speculate about all sorts of things, you can say "Well, if the retailers and the manufacturers were conspiring, then they might be able to find ways whereby the manufacturer, here Imperial, could pay the retailer to do something which suited him". But that isn't the evidence. There is no evidence of lump sum payments. That's where they were in the Shaffer 2010 report. Nor is there evidence of anything else. So what you are left with on the evidence is, there is no point having idle speculation as to whether there might be some means whereby retailers could be incentivised to do something which is against their interest. The question is the OFT is saying they did, there is no evidence that they were incentivised, so how do you explain that? All that the OFT actually says is "Oh, well, we say they did, therefore they must have done, therefore it doesn't matter". But you have to ask yourselves: did they? I can see it is not in their economic interests to do so, so do I find that they did something that makes no economic sense for them? In our submission, the answer to that is relatively straightforward.

I have skipped over that rather quickly, there is quite a lot of material, but the final point I want to make on this is that, if one takes it in stages and just thinks about it, Professor Shaffer's original model is based upon all the bargaining power being with the manufacturers. Well, anybody with any knowledge about anything to do with the UK economy knows that is nonsense. So then he speculated in the 2010 report, and said it would be possible for there to be lump sum payments. That's been shown not to be the case. It has also been shown to be the case that the incentives provided by the RMS agreements were very small indeed, and they couldn't be sufficient to compensate for the losses which Professor Shaffer accepts on his approach would be suffered. We are then left with "Oh, there could be other things". No-one on the OFT -- it is not a criticism of Professor Shaffer because he is approaching hinges as an academic economist, but the OFT, having sought to say "Well, here are the facts which show there are other means" and in fact not only have they sought to do that, Mr Ridyard in his final report has explained that if it were truly the case that other means of payment were being provided to the retailers, what you would expect to see is a step change in the relative profits of participating and non-participating retailers when the alleged infringements were terminated, but he in his report has demonstrated that is not the case.

But in fact before you get there, the onus was on

the OFT to say "Well, here you are, this is it". They can't do that, so they are putting their heads in the sand and just saying "None of this is relevant because I simply say there is the agreement". As I say, that's because they are not approaching it correctly, asking: was there?

So to pause for breath, it's clear that the theory of harm, as endorsed by Professor Shaffer, is based on his assumption of a state of affairs which is belied by the evidence and by common sense, in particular the alleged agreements particularly make no sense from the point of view of Imperial and importantly the retailers who would have suffered significant losses if they had entered into them.

So that takes me to the revised theory that we are now dealing with. The OFT from time to time recognises that the evidence doesn't support the assumption of rigidity which we have been discussing. I'll have to show you one or two points where they accept that, and how they deal with it. The first place to look is in the defence at core 4, paragraph 197 page 227. {C4/227 paragraph 197}. If we just track through how this paragraph works, at 197.1 they say their case is that the ITL required retailers to implement parity or fixed differential requirements.

Then at 2 they are dealing with their case on lack of incentive. At subparagraph 4, it's 197.4 on page 78 that one particularly needs to deal with. This is dealing with wholesale price increases. So what they say is:

"The OFT notes that the manufacturers generally implemented MPIs at about the same time, so that MPIs did not tend to result in any divergence from the manufacturers' parity and differential requirements."

Stopping there for a moment, what they are saying is in fact the manufacturers were implementing MPIs at more or less the same time. In other words, their case on the retailers being obliged to do something independent of manufacturers' price increases doesn't actually apply on the facts.

Then they say, notwithstanding that general point, and this is the paragraph we need to look at rather carefully, they rely on their response to paragraph A, specifically that number, thus, and this is the important thing:

"In a scenario in which Gallaher increased its prices before ITL, the realignment of prices with ITL's parity or differential requirement might be brought about in a number of ways. ITL might choose to respond to respond to that price increase with its own price

increase and instruct the retailer accordingly. For that purpose, the retailer might have provided ITL with notification or indeed advance warning of the competing manufacturers' price changes.

"Alternatively, in a scenario in which ITL raised its prices before Gallaher, a realignment of ITL's parity and differential requirements might be brought about by ITL encouraging, instructing or requiring the retailer to change the price of the linked Gallaher product or by ITL asking the retailer to increase prices subject to compliance with its P&D requirements."

This paragraph is actually very revealing.

Take the first situation they are referring to, that ITL chooses to respond to a Gallaher price increase. This is simply a case where one manufacturer chooses to follow a price increase of his rival, no doubt because he has either been affected by the same factors that drive manufacturer price increases or because he sees it as an opportunity in any event to increase his price. But there is no requirement on the retailer to do anything. It is affected by here Imperial's price increase, but it's not required to put up Imperial's retail price, although it will usually do so because otherwise its margin will be reduced. But it has nothing to do with the RMS operating in some adverse way. This is just Imperial putting up its price, its wholesale price, and the retailer -- it says they instruct the retailer accordingly. It's up to the retailer whether if Imperial puts up its price they put up Imperial's retail price, but invariably they will do so, because --

THE CHAIRMAN: That's the question we have to decide, isn't it, whether that is the case that the retailer was free to respond to the ITL decrease by decreasing the shelf price?

MR HOWARD: No, no, we are not talking about that, this is -- the sentence I am focusing on is Gallaher --

THE CHAIRMAN: I see, yes, within prices it is the other way round.

MR HOWARD: This is very important to focus on. This is about the central part of the case. This is about the price increase. Gallaher's price is increased. So the first example they give, they say Imperial puts up its wholesale price in response to Gallaher.

Just stop for a moment. Is there something that precludes Imperial doing that? The answer is self-evidently not, it's entitled to put up its price because of factors that affect it, which may include the fact that its competitor is putting up the price.

In other words, the first example they put is there

is nothing sinister about Imperial putting up its price. Imperial, when it puts up its price in response to Gallaher, doesn't have a requirement that the retailer puts up the retail price of Imperial's product. It recognises the retailer will wish to do so because it's in the retailer's interest, otherwise his margin will be cut.

That's all that's happening in the first example. It's not any obligation on the retailer. You have to remember, the case that's being made by Professor Shaffer is moving prices of Imperial up simply because Gallaher has moved up. This is the opposite. This is you are moving the price of Imperial up because Imperial's put up its price.

Now, it's not that it doesn't take their case anywhere, it's actually against their case.

You then have this allegation the retailer might have provided ITL with notification or advance warning. Now, again the hub and spoke allegation of inappropriate pricing information being provided and acted on, that's no longer part of the case, and in fact in relation to Gallaher price increases, you have to remember this isn't an opportunity to respond case, there is no basis for saying that there was any expectation on the retailers to tell Imperial. What actually happened

generally was that -- you have seen in the correspondence we have looked at -- either Imperial sees something happening on the shop floor, or through some market awareness it has, it says "I believe they are going up, I am putting up my price" but usually it's not MPIs going on that we have seen in the correspondence, it's usually withdrawing a payment of tactical bonuses.

The other point that is then made in the next sentence is this reference to encouraging, instructing or requiring the retailer to change the price. Well, what it is true to say is I showed you the letter they rely on where there was said "How about encouraging Gallaher", but the point is it was not encouraging the retailer independently to change the price of Gallaher, that letter; what it was saying is "Why don't you try and get Gallaher to put up their prices". As I said, that may or may not be something they should be saying, but it's not supporting the case that's being run.

This is a very important point: once you relax the assumption of rigidity, and the OFT in relation at this stage to price increases has to recognise that. I'll just remind you again, it's worth going back to paragraph 35 in this document. Paragraph 35 --

DR SCOTT: Sorry, which --

MR HOWARD: This document, the defence. Paragraph 35,

remember we looked at it before, which is the central component of their case, is that there is a requirement that the brands are linked so that if A puts up his price he can be confident that the price of B will go up. It's the central plank, and that central plank is entirely dependent upon there being this obligation on the retailer. Once you recognise there is no obligation on the retailer, no requirement, but all that happens is that sometimes Imperial itself puts up the price, where does the central plank stand? There is no theory of harm that supports the case once you take away, in relation to this price increase, the central plank, there is no theory of harm explaining why anything that's going on is anticompetitive.

They have an alternative theory of harm relating to price decreases, but in relation to the central plank they don't have one at all. The central plank stands or falls on whether the RMSs operated in the rigid manner. They did not, and the central plank disappears.

Now, leaving that on one side, once the rigid assumption disappears, let's say that they say "No, no, I'm misunderstanding it and there still is", the question is: okay, what now? The rigidity has gone, what now is the nature of the alleged agreement or practice which is said to be anticompetitive? Because previously one could see there was a case there was a requirement that the retailers have to move Gallaher's price up in line with an increase in Imperial's wholesale price, and a requirement to move Imperial's retail price up in line with an increase in Gallaher's price. Once you take that away, what is the case? If there is no requirement, and we say clearly there wasn't, what is the OFT then complaining about? Because you have to remember, again, the OFT's core complaint was that the retailer was prevented from favouring Gallaher. Now, what is it that gave rise to that? Well, previously one understands it, but once you take away the requirement, take away the rigidity, it's difficult to follow what the complaint is.

You then have to ask yourself: what is it you are complaining about which is any different from the way in which a market works, particularly a market where the -- which is highly regulated, highly taxed, transparent and, as the Chairman has pointed out, concentrated where you have two major players, where there may be a tendency for them -- obviously for them to watch each other, and sometimes, and indeed very often as the OFT themselves say, to follow manufacturing price increases or to apply them at the same time?

So in relation to the central plank, we say the case

is very difficult to understand and it falls away, once you take away the rigidity.

The revised theory has emerged when they have tried to deal with price decreases and the opportunity to respond. In relation to price reductions, the OFT has recognised that they cannot maintain their case that there was an automatic change at all times, and you will see that in the decision, and the particularly relevant parts are in the decision at 6/92. At 6/92, the OFT considers that:

"Although the retailer may not have automatically changed the retail price in response to a change in the price of the competing linked brand in every case, the parity and differential requirements created the expectation that even the retailer would seek to be granted permission from the manufacturer to move the price of et cetera product in line with the P&D requirement or the manufacturer would instigate the price alignment itself in order to maintain its parity and differential requirements."

A similar point you will see, or the point explained more, at page 124 of the decision, 6.223 and 6.224.

This is the, as far as one can see, recognition in these paragraphs of the right to respond, and in the defence the right to respond specifically is referred to

at paragraph 197. But what one just sees -- I ask you separately to look at paragraph 197 -- is that the OFT is recognising that the RMSs operated in the following fashion: firstly, leaving aside the question of incentives and so on, the retailers were able to reduce the price of a Gallaher brand without automatically reducing the price of the competing Imperial brand. Indeed, recognising that, although this comes in almost as a side wind in their decision, the effect of that is that practically all the work of Professor Shaffer is irrelevant, because it's based upon this rigid lock-step.

The effect of that is that the differentials if Gallaher puts down its price change, then you have a situation where Imperial might respond by itself having a tactical bonus or might choose not to respond.

The final position is that the retailers were free, whether to accept Imperial's response or not. There is no obligation on them to do so. Obviously, if the response is in their interest, ie Imperial saying "We are prepared to match what Tesco is doing and throw money at them", one can't see any economic reason why they would not do so.

DR SCOTT: I suppose what I lost sight of in this account is where the bonuses are and are not being paid. Now, if

I go back to the trading agreements, my recollection was that there were moments when the bonuses were not withdrawn in certain circumstances.

MR HOWARD: Sorry, were not withdrawn? Are you asking me whether as a matter of fact the bonuses were withdrawn?

DR SCOTT: No, I seem to remember in some of the trading agreements there was a statement that in certain circumstances the bonuses would not be withdrawn, that Imperial chose not to --

MR HOWARD: They would not be withdrawn if Gallaher's price came down and Imperial didn't match it.

DR SCOTT: That's right.

MR HOWARD: In other words there is no obligation on you, retailer, to move our price down, and indeed we are going to continue to incentivise you even if we don't throw more money at you to try and meet Gallaher. In other words, it's entirely the opposite to the case that's being suggested.

DR SCOTT: That was my recollection.

MR HOWARD: And it's a very important point, sir, that actually the way those were operating on their face is that, far from creating some expectation that the retailer will move Imperial's retail price down, saying, "Well, we recognise that Gallaher may do significant that puts you at a competitive disadvantage, but you mustn't feel we are not going to pay you a bonus, Mr Retailer, we may try and pay special tactical bonuses in order to make ourselves more competitive in that situation, but if we don't, you will not be prejudiced, providing you stick with the position as it was before, in other words don't prejudice us beyond the degree to which Gallaher's price cut has prejudiced us, you will still get your bonus".

All of that is self-evidently and obviously pro-competitive. It's not in any way inhibiting by the terms of the agreements Gallaher cutting its prices. What is an entirely separate matter is the notion, which is of course something highly uncertain, which would obviously require an effects analysis, saying if you have a concentrated market and manufacturers are price cutting, after a while they may independently cease to price cut. We all know that is something that can happen. But there is absolutely no certainty, it all depends upon market dynamics, upon the interests of each trying to gain market share and things of that sort.

Now, the difficulty with the OFT's case, and again you have to always remember, this is a case about an object infringement, that once you move off this rigid assumption, they have then got to explain how it is -- we say they are wrong on that -- because we

understand how they articulate it, once you are into this area of people being able to respond and counter respond, how you say -- firstly what it is you are actually saying is wrong with the agreement, and secondly, how that is going to create an anticompetitive situation, where what is actually designed from Imperial's point of view is to create a competitive situation.

Now, the way in which Professor Shaffer tries to deal with this is his concept of uncertain compliance, and you will see that -- I am not going to take you to large tracts of it, but this concept featured in his 2010 report at paragraph 160, it's in core 6, tab 65. {C6/65 paragraph 160}

Again, one needs to look at this quite carefully and just think: what is actually being said, see how this fits in. He has previously got his absolutely rigid lock-step, and paragraph 157 makes it clear that it's rigid and there is a full 100 per cent compliance. Then he claims at 158 he was looking at it on this basis because he wanted to isolate the economic effects of the requirements. Note the important word, the requirements, when taken at face value.

He then at 160 says:

"I am going to analyse the impact on competition

when compliance is not certain. A retailer may or may not realign a parity or differential after a wholesale price change by the manufacturer."

Now, what he says are the three possible causes for non-compliance, the first one is an error by the retailer. Now, if one just stops for a moment, an error by the retailer, and of course the world isn't perfect, and if, let's assume he is right or his assumptions were right, there were these rigid requirements, but you can't be 100 per cent certain that the world works perfectly, well, one can see that doesn't affect his theory, everybody knows that nothing works perfectly, so that's an illusory point.

His next point is at 162, and that's where he says that:

"Compliance with the requirements may also be uncertain because the retailer may sometimes choose not to comply. For example, it may comply with the requirements 80 per cent of the time and not the other 20 per cent, or it may be that the retailer's trading arrangement with the rival manufacturer requires it to let the rival respond before it changes the retail price of the rival's product. The rival manufacturer may choose for whatever reason not to respond to the initial manufacturer's price change."

All of this begs a very important question: comply with what? The premise of the error is that there is a requirement for rigid price increases and reductions, his lock-step.

His second example, which is the first in 162, is there is that requirement, but the retailer is just being naughty and not complying all the time; he chooses to. Of course that anticipates that the retailer actually begs the question: was he obliged to do something or was that how he was entitled to behave?

It takes you back to: require with what? And the requirement has to be, to make sense of this, a requirement of his lock-step. So what he is saying is there is a requirement of lock-step, but it might not always be observed because the retailer is breaching what he is required to do.

You have seen the evidence and I've explained to you, there simply is no requirement that the retailers have to move the prices absent wholesale price changes by one or other.

DR SCOTT: To be clear, what you appear to be saying to us is that the use of the word "error", which occurs quite a lot in the evidence, is Imperial helping the retailer by saying "You have erred from your own retailer strategy", not saying "You have erred by breaching our trading arrangement". Is that what you are saying?

MR HOWARD: Yes.

DR SCOTT: So although that word "error" occurs frequently, you are saying that's how it's used?

MR HOWARD: Yes. The answer is yes, the correspondence that is referred to, one sees they are talking about an error, it's for instance in Safeway, because that's I think where it particularly featured, there is error by you, Safeway, in what we understand to be your strategy.

Now, that strategy may be both as to the way they are going to price generally in their store, and it may be that they understand that Safeway are intending to implement the price differentials in order to earn the bonus. So it covers that situation, it's not saying it's simply an error. It's an error in the pricing, but what one then finds is that Safeway in those examples don't change the prices because it isn't an error, so Imperial has just got it wrong.

I just want then to go back to what Professor Shaffer is saying, he is talking about something different here, it's not by reference to any of the correspondence. The first point he was making is just an obvious point, that there is a requirement that you assume his assumption, the requirement is the

retailer must always do X. The fact that that is, let's say, a strict requirement, that's what the contract says; the fact they only do it in 5 per cent of the cases because they are shoddy doesn't tell you anything, it's just that that's the nature of the world, that people aren't perfect and no doubt it's very complicated setting prices in supermarkets and so on. So there is just nothing to discuss on that.

It's his other two examples which are of greater importance. The first is that the retailers may sometimes choose not to comply, but there again what he is saying is there is, for the purposes of this theory, an absolute obligation, but then it's recognising that the retailers just don't perform the obligation.

Now, there is either a obligation, in which case you are saying, well, even though, although it's an obligation I can't be certain the retailers will perform it, although it seems a rather odd situation, what you are actually saying is the retailers have a discretion to do what they want when it suits them; or what you are actually recognising is that there is no obligation in the first place, no requirement to which they have to adhere.

The third scenario is actually what we are really dealing with, because the third scenario is where, in

this throwaway line, he refers to the opportunity to respond clause. So this is a situation, he says:

"It may be the retailer's trading agreement requires it to let the rival respond before it changes the retail price of the rival's product, and the rival manufacturer may choose for whatever reason not to respond to the initial manufacturer's price change."

Stopping there for a moment, the way he put this is entirely of course very tendentious and not an accurate description of the opportunity to respond clause, because he is putting it round that the retailer wants to change, as it were, the price of Imperial because Gallaher has put the price down, but before he can do so, he has to let the rival manufacturer, here Imperial, decide whether it wishes to do so.

Of course, what is actually happening is Gallaher cuts the price, Imperial decides whether or not it's going to cut its wholesale price by means of giving a tactical bonus or not. In other words, there is no requirement, it has nothing to do with his lock-step, it's an entirely different scenario. So what he is trying to shoehorn into his theory by his model of lock-step is something which is completely different. That's the point that has been made by the various experts for the appellants.

Now, it's graphically summarised by Professor Froeb as a theory that a bad thing some of the time is still bad. But of course the point he is making is: what you actually have got to do is look at the nature of the agreement and the nature of the agreement here is wholly different to that on which the OFT's case and Professor Shaffer's theory is based.

What both Professor Shaffer and the OFT have to do here is try to elide two different situations, their allegation that there is a rigid scenario with the recognition that actually that isn't the case and somehow to elide the two situations and to treat one as being a variant on the other.

But again, once you take away the central plank, we have already seen that the central plank of the case falls away relating to price increases. We consider the case about price reductions: where Imperial reduces its price, there is absolutely no obligation on the retailer to reduce the price of Gallaher. That's perfectly clear, and the opportunity to respond clause has nothing to do with that. Where Gallaher reduces its price, there is no obligation on the retailer, it's all the opposite, it's simply if Imperial chooses to respond then if it cuts its price and pays a bonus on the basis that you will cut the price, then that's what happens.

If you take away the rigid assumption in relation to the price reduction case, what is the aspect of the agreement that is being complained of? Again, ask yourself: what is the restriction on the retailer that prevents the retailer favouring Gallaher? What, again, you should ask yourself, in this instance, is the theory of harm and what is any empirical evidence in support of it?

Now, can I just at this point, just before concluding, make some points about parallel and symmetrical which I can fit in at this stage.

In the decision, in section 6, at the beginning and end of the retailer sections, the OFT finds that both manufacturers communicated parallel and symmetrical parity and differential requirements to the retailer and that each manufacturer must have been aware of the other's parallel and symmetrical parity and differential requirements, and that reinforced and increased the inherently restrictive nature of each infringing agreement.

So that's the assertion. Can I ask you to take the decision at section 6, and if you turn to page 116 of the decision, you will see that the material relied on in support of parallel and symmetrical runs from 6.154 to 6.178. Basically, a handful of documents. Just

before I say anything more about that, I just want to clarify, which is important, particularly I think in light of some of the questions, about parallel and symmetrical. Imperial's RMS schedules are based upon its strategy which it based upon the RRPs, but its strategy was therefore, once it had set its RRPs and saw the RRPs of its competitor, for it to decide which products it wanted to promote by reference to those differentials, and also in which retailers. So in other words, Imperial had its strategy, which is brand and retailer specific.

Gallaher may well have a completely different strategy, both as to brands and retailers. It may have a completely different strategy, full stop. But insofar as it is seeking to incentivise retailers, it will have a different strategy, and indeed that's what the evidence shows, vis-a-vis different retailers and different brands, and that's why you don't find a complete overlap of retailers, or the same brands being matched. So in other words they have different strategies. That's a very important point to understand.

Now, after the decision, Mr Ridyard's report was produced, which showed that the OFT's allegation of parallel and symmetrical was not supported by the

evidence, in that only firstly Shell, TM Retail and TS Trading had trading agreements with both Imperial and Gallaher at the same time, and 80 per cent of the identified brand pairs in Imperial's trading agreements didn't match the brand pairs in Gallaher's trading agreements.

Moreover, far from being symmetrical, there were many cases where the differential provisions, even where there was that overlap, were inconsistent.

Where we are is that in the defence -- and it is worth pointing you to this -- at paragraph 277, we may have looked at that this morning, actually, it's Core 4, tab 45, a couple of references to pick up, paragraph 277 {C4/45 paragraph 277}. The position in the decision is that:

"The existence of parallel and symmetrical parity and differential requirements is not a necessary part of the finding of an infringement by object."

They rely on:

"It's however relevant to the expected impact of each infringing agreement."

Then if you go to paragraph 282, this is what they now say:

"Thus the OFT's case is that there is a significant degree of similarity between the infringing agreements

and that similarity is material to the expected impact of the infringing agreements. This view is supported by Professor Shaffer."

So in other words, actual parallel and symmetrical has gone, we now have significant degree of similarity, which is material to the expected impact, and then as to knowledge, paragraph 301:

"The manufacturers were not privy to all of the evidence on which the OFT relies. However, assuming that is correct in its generality, ie that they weren't privy to the evidence [well, that's common ground], it doesn't follow the manufacturers were not aware of each others' infringing agreements and the existence of parallel and symmetrical requirements under those agreements."

Since they don't seem to be saying there were parallel and symmetrical requirements, quite difficult to follow. Then they say:

"The evidence shows that each manufacturer [of course we are not going to hear from Gallaher, put that to one side] was aware in general terms of the other manufacturer's pricing strategy and in some respects of the detail of the requirements under that strategy. The manufacturers could be expected to draw further inferences as to the content of each others' infringing agreements based on their observation of each others' prices."

If what is being said is Imperial can deduce what is Gallaher's strategy, then the answer to that is they can do that today, because they can see the extent to which Gallaher price promotes particular brands and is trying to undercut, they know which sector brands are falling into, so they both know, for instance, that Dorchester and Richmond are part of this ultra low price, so they know that if Gallaher is promoting its brand that what they are trying to do is to gain market share in the ultra low price sector of which -- whichever, I can't remember which it is -- Imperial's Richmond is part. That's nothing to do with the RMSs.

Now, it is fair to point out that the OFT has sought, in annex 14 to the defence, to remedy the evidential deficiencies in the decision by putting forward additional schedules. That we have replied to, and we say it doesn't show anything at all. But there is a prior point as to whether or not the OFT should, by its defence, be entitled to put in this new annex. We suggest that that is embroidering, which it is not entitled to do.

In any event, similarity, awareness in general terms is not sufficient for the OFT's purposes, whether you

are looking at their theory of the lock-step mechanism or the uncertain compliance.

Now, I see the time. I have probably about another half an hour. I understand that my learned friend Ms Rose is in difficulties. We realise that we have taken slightly beyond our allotted time, but the way in which we hope we could deal with things is if I could take until 2.30, if Shell could then open their case until 4.30, and then on Monday morning we could complete with Mr Brealey making some observations on object, and possibly on exclusion and exemption, and then hopefully catch up in the course of next week. I apologise, but obviously I have the lion's share of opening.

THE CHAIRMAN: It's partly our fault for interrupting you, but it's useful to clarify these things at the start.

MR HOWARD: And I welcome intervention from the Tribunal, because they are important for clarification.

THE CHAIRMAN: Well, we will come back, then, at five past 2 and continue with you and then hear from Ms Rose and then Mr Brealey on Monday morning.

MR HOWARD: I am grateful.

(1.05 pm)

(The short adjournment)

(2.05 pm)

MR HOWARD: So, we had been looking at the basis of the

theory of harm. If we go back a stage, what we are looking at is the price reduction scenario, if you want to go back on price increase. Imperial's desire to undercut one of its rivals here, Gallaher, is self-evidently pro-competitive behaviour, and an arrangement by which retailers allowed Imperial an opportunity to respond is simply a manifestation, we would suggest, of legitimate competition between manufacturers. When one said allowed, of course the retailers are not actually allowing anything in any real sense, because, as I have already explained, there is nothing ever to stop one manufacturer reducing his price. In other words, the opportunity to respond doesn't actually add anything. That's why in the cases where it is not present, Imperial was enabled to act in exactly the same way, which is to say "I see Gallaher's price, there seems to be a Gallaher price promotion and you are selling them below me, I am going to do my own price promotion", and of course there would never be anything that would stop you doing that.

What's important to observe is that Professor Shaffer's rigid assumption is key to, we say, the OFT's case. As Professor Froeb points out, once you relax that assumption, you get -- even on Professor Shaffer's model and even assuming that such

a simplistic model has relevance -- a different result.

Professor Froeb you will find in core 3 at tab 31, and this is his report from March of this year in reply to Professor Shaffer.

At paragraphs 93 to 95, {C3/31 paragraph 93} he explains that using precisely Dr Shaffer's mathematical setting and methodology -- stopping for a moment, he doesn't accept that this mathematical setting and methodology are appropriate, he is just taking what Professor Shaffer has done and he allows for a link between the wholesale prices and RMS terms, then he adopts a:

"... revised assumption that if one manufacturer were to raise its wholesale price while the other does not, it should expect that the parity agreement would be replaced with a differential agreement proportional to its price increase. Alternately, if a manufacturer lowers its price by, say, 3p, it should expect that the differential would also adjust ..."

"Altering this one assumption entirely overturns the result Professor Shaffer derived from his model. In particular, the adoption of RMSs reduces wholesale and retail prices and benefits the consumer. The economic intuition for this change is straightforward. A wholesale price decrease by one manufacturer shifts retail prices in its favour, providing a greater incentive to reduce prices. This encourages the rival manufacturer to also reduce its price to re-establish parity and so on. This virtuous cycle leads to lower wholesale and retail prices."

Stopping for a moment, of course in fact the point that Professor Froeb was making, he is simply saying if one manufacturer has the ability to price cut, then and his price cut will be implemented, then, and he can feed that through to the retail price, then he will try and cut his price because that's a way of getting market share, so that's pro-competitive.

The point he is making then in paragraph 95:

"Given how sensitive Professor Shaffer's results are to his assumption that RMSs are rigid and non-negotiable, I do not believe that his theoretical conclusions can be seen as conclusive. If RMSs are renegotiable upon changes and wholesale prices (as both Professor Shaffer and the OFT allow) then his own model suggests that they are likely to be pro-competitive. In either case, if there is any doubt about the specific mechanics of these agreements, the conflicting results of Professor Shaffer's and my assumptions suggests an effects-based inquiry, rather than object based, is more appropriate."

In fact, Professor Shaffer, you will see, there are two references where he recognises that once you relax his assumption, that may have a pro-competitive effect.

The first is in his 2007 report, which you have in core 6 at tab 64. If you go to paragraph 51, he says:

"One caveat to this is that the reasoning above presumes that the retailers are required to maintain the parity and differentials as specified in their trading arrangements, regardless of any disparities in each retailer's wholesale prices."

Stopping there for a moment, my reasoning, he is saying, has been on the basis of the assumption that parity and differential requirements were required to be maintained even where the manufacturers changed the wholesale price.

He then says:

"If, on the other hand, manufacturer B's wholesale prices are not fixed and if manufacturer A is committed to matching any lower wholesale price offered by manufacturer B as a way to ensure that retailers maintain parity, then the retailer's incentives to obtain lower wholesale prices may increase when they have trading arrangements. This is because in this case a strategic retailer may be able to parlay a wholesale price concession from one manufacturer into a lower

wholesale price from the other manufacturer, thereby increasing its ability and incentive to negotiate a lower wholesale price."

In other words, what he is focusing on here is simply a situation where the retailer knows that Imperial, say, is committed, is the way he puts it, to matching a lower wholesale price offered by Gallaher. The retailer has no obligation to do anything, but what he does is he may put down the price and then he -- not because actually Gallaher in this example have reduced the price but because he is just trying to negotiate a lower wholesale price from Imperial. In other words, he uses the fact that he is essentially at liberty to do what he likes to get one manufacturer to reduce the wholesale price, making him believe that he has got to do that in order to be competitive.

Now, he is right about that, that's one effect of the way all of this can operate. But the other -- so there is one caveat to his view -- caveat you will find in the joint experts' statement in core bundle 12 at tab 125, page 58. {CB12/125/58}. The statement is:

"Under appellant expert's interpretation of the P&Ds, retail prices would be expected to be lower with P&Ds than in the absence of the P&Ds."

His evidence is he agrees. What he then says is:

"Under Froeb and Dryden's interpretation, in those circumstances in which we see P&Ds, I would expect that at least some retail prices would be lower than in the absence of P&Ds. However, if there are periods in which there is a lag between the two manufacturers' announcements of their wholesale prices I would expect to observe one manufacturer's retail price going up and the other manufacturer's retail price going down in order to maintain the margin parity.

"Furthermore, as stated previously, I am currently unaware of plausible circumstances under which certain manufacturers would find it profitable to offer P&Ds under these interpretations."

The key point is if Professor Shaffer's assumption is wrong as to the way the P&Ds operate and the appellants' experts' understanding of how they operate is correct, will they lead to lower prices, his answer is yes, they will. He has a caveat for a particular circumstance but in relation to the overall position it doesn't make any difference.

Just to interpose here, the central plank point which I have already discussed in relation to price increases is not being addressed.

What one would have thought in the light of paragraph 51 of the 2007 report and the statement here, and the light of the fact that the OFT is forced to acknowledge that there was no automatic obligation, in fact one sees what they have said about the right to respond, one would have thought they would then have to acknowledge that that was the end of the case, because what is the anticompetitive effect of which they are complaining?

What you will then see is there is yet a further variant coming forward, and now the variant is this: the RMSs, it appears, are said to be nonetheless anticompetitive because they make it easier for Imperial to match price changes by Gallaher, and therefore, because Imperial's going to be able to compete more effectively with Gallaher and reduce prices, over time they say that will disincentivise Gallaher from reducing its prices. That's the further variant upon the case.

This comes forward very much, we would suggest, as a sleight of hand. The way you will see it, and this is interesting, is if you still have to hand the joint statement, if you would turn to page 74, the Chairman will remember that we had a rather tedious debate about who was going to do the drafting and so on, and so this document appears in two parts. This is the part which was drafted by the appellant experts, and you can see part 1 was:

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

This is rather important.

"The following propositions set out the appellant experts' understanding of the assumptions adopted by Professor Shaffer. 1. Where the relative retail prices of brands A and B are linked in P&Ds, if the differentials in the P&Ds were fixed, Professor Shaffer's static theory of harm assumes there is an obligation upon each retailer to increase and/or decrease the retail price of brands A and B in parallel following any increase and/or decrease in the wholesale price."

Then they set out the mechanisms, which is the lock-step, that that was a requirement. Now, if you look at all of the appellants' experts, they explain that that is what they understand Professor Shaffer's report says, and indeed that is what Professor Shaffer's report says.

What you will find here --

THE CHAIRMAN: Those (i) to (iv), do those map onto the paragraph 40 that we saw in the skeleton?

MR HOWARD: They do. The wording may not be identical, but they certainly map on in the sense of the same concepts.

What is then interesting, unanimity, they all agree,

but Professor Shaffer, you will see, is now -- there is a bit of a departure here, because he says:

"I agree that under the OFT's interpretation of P&Ds, if the specified P&D differential between brands A and B were fixed, then the retailer would be expected to increase or decrease the retail prices of brands A and B in parallel, following an increase/decrease in the wholesale price. The framework I set out in my 2010 report explains why this would be expected to be anticompetitive. The key to the theory of harm is that with P&Ds retail prices would be expected to move in the same direction following a wholesale price change, whereas in the counterfactual world without P&Ds, there would either be no such expectation or, if there was such an expectation, the retailer would not be expected in the absence of P&Ds to change the retail price of the rival brands by as much as it would change it with P&Ds."

Now, this appears to be putting forward a rather different case, which is, you remember, in Professor Shaffer's report you had the requirement of lock-step, then he modified that with uncertain compliance; now, what he appears to be saying, when the very assumptions are defined, he seems reluctant to agree that these were his assumptions, which you can see

absolutely clearly laid out in that report, and instead puts forward the explanation here.

Now, the points one can make about this are as follows: firstly, Professor Shaffer's theory and model were clearly articulated on the basis of a supposed lock-step. It's also clear, secondly, that therefore his theory was based on something which bore no relationship to the facts. Thirdly, Professor Shaffer now appears to be moving away from his lock-step, his case based on requirements of Imperial and obligations on the retailer, which was something everybody understood he was talking about. Now we appear to be in something very vague and amorphous, we are away from obligations and restrictions, and in a world where there is an expectation that fixed differentials will continue to be applied. No doubt he would alternatively say, if it's maxima differentials, an expectation that they would be applied.

But all of this, with respect, begs the key question: what is the nature of the agreement about which complaint is made? What is the restriction that is now said to apply? Because what appears to be contemplated is that, although the P&Ds or the RMSs, whatever you want to call it, do not impose any requirement, they may in some ill-defined way give rise to an expectation, which expectation may have an effect, but in what way? And the question that of course is not addressed, let alone answered: how is any of this different to the effect of the nature of this market, transparent, concentrated, highly taxed and regulated? What is the theory of harm? What is the empirical evidence that is supporting it, other than pure assertion by Professor Shaffer? There is absolutely nothing. Moreover, whether or not over time a situation might arise in which, because of the nature of the market, it's said manufacturers are not competing as vigorously as they might, that requires an effects analysis.

If it's being said the existence of the RMSs somehow increased the likelihood that a price reduction by one manufacturer will be followed by a price reduction by the other manufacturer, one has to compare that with the situation where they are price cutting without the RMSs. In other words, why does the RMS make any difference at all? But even if you say, well, it may make it more likely that one manufacturer is going to price cut, why is that a bad thing? Prima facie it's a jolly good thing. If you are then going to say, well, the fact that it's more likely that Imperial will price cut and you are then saying that will have an anticompetitive

effect in the long-term, it's not rocket science, this, you would need to -- this would be something which is vigorously challenged -- look at the empirical evidence. You can't just have Professor Shaffer saying "I feel it in my bones that over time, somehow this is going to result in higher prices", and that's basically what we are left with.

One can make a couple of points, really, as a matter of common sense, where one doesn't need a PhD in economics, whether or not a manufacturer chooses to compete on price will depend on the dynamics of the market. For example, when Gallaher is considering whether to implement a price cut, it must no doubt ask itself: what is the likelihood that Imperial will respond? And then it will ask itself: well, what's the size of the cut I am going to make? Then it will think: well, Imperial will have to think how long I'm likely to make this cut for, is it in Imperial's interest to match it, what other promotional activity are they funding? There are a whole series of things.

This is self-evidently not susceptible to some simplistic model of the type that Professor Shaffer put forward in 2007, which is based -- his model is based upon rigid assumptions. What you can't do, and this is basically where one gets to, you get a model which is

based upon these very rigid assumptions and then what is sought to do is to jump and say "Well, never mind that", everything that the model shows is somehow still true in relation to what is a very different environment.

So once you recognise that the RMSs do not operate in the rigid manner, we suggest it is particularly counterintuitive to seek to classify them as an object infringement.

Now, there are a couple of sense checks which are important in relation to this. I remind you that Professor Shaffer's evidence is that from the moment the RMSs were agreed they had an anticompetitive effect. Well, if that were true, then Professor Shaffer's theory would easily be demonstrated.

Now, the evidence shows that in relation to a number of aspects empirically they contradict what Professor Shaffer puts forward. Market share, Imperial, during the relevant period, gained market share. You will find that evidence in both Mr Good's statement and in -- that's in Mr Good's first statement at paragraph 32, core 3, tab 36, {C3/36 paragraph 32} and the market share increase between 1999 and 2003 is in the notice of appeal, core 1, tab 2, {C1/2} when Imperial gained 6.1 per cent and Gallaher lost 2.4 per cent.

Prices. The weighted average real prices of Imperial's brands increased more rapidly after the alleged infringement period. That's set out in Mr Haberman's report at paragraphs 4.1 to 4.17. These figures are accepted by the OFT's expert, Mr Walker, see core 12, tab 124, page 6. {C12/124/6}.

So what does the OFT seek to do? They seek to dismiss the relevance of these figures, see paragraph 42.4 of the defence. But Mr Haberman has specifically ruled out the possibility that this factor can be attributed to any increase in costs or any fundamental change in the market structure or material change in the tobacco taxes. Mr Walker has since agreed that the evolution of retail prices is not explained by changes in Imperial's costs. That's core 12, tab 124, page 6. {C12/124/6} So that contradicts.

Manufacturers' margins. The evidence shows that Imperial's real gross profit margins were higher in the post infringement period than during it. That's table 10 in Mr Ridyard's second report, core 3, tab 26, page 154. {C3/26/154}

Mr Ridyard explains that that isn't definitive proof, but it is a useful contraindicate because if it were true that the existence of these agreements had serious anticompetitive effects, one would expect to see a major change in the nature of competition and profitability.

The next point, which perhaps it is worth looking at the joint statement for this, which is variability. Mr Ridyard carried out a variability analysis which tests whether the difference between the retail prices of the brands that were paired in Imperial's RMSs were subject to greater variability whilst the RMSs were in place when compared to the subsequent period.

If you go to core bundle 12, at page 16, {C12/16 paragraph 2.6}:

"On the assumption that greater volatility in the relative price of paired brands was observed during the alleged period and afterwards, we disagree on the consequences of any such observations."

Ridyard believes that:

"Such findings would be inconsistent with the theory of harm because the mechanism for interprice brand co-ordination described in that theory relies on RMSs creating a tighter link between competing brands' relative prices than would otherwise exist."

Walker:

"... [does] not believe that there is a theoretical justification for believing that the alleged infringing agreement should reduce volatility."

If you then look at the clarification of the experts, Mr Ridyard:

"The OFT's theory of harm alleges that the RMSs increase the likelihood that one manufacturer's unilateral price increase or decrease would be matched by its rival and that through the RMSs, it was the pricing decisions of participating retailers that played this role of co-ordinating into brand competition by keeping the relative prices of paired brands in line with one another than they would otherwise have been. If that was true, then I would expect to see greater stability in the relative retail prices of paired brands when they were covered by RMSs than when they were not."

Mr Walker simply says that:

"The theory of harm doesn't include a prediction about the effect on price volatility."

It may not expressly, but that's obviously the implicit basis of it, and that's the basis of the conclusion you would draw from what Professor Shaffer has said.

So that's a further counter indicator.

Then the performance of Richmond in particular, Imperial gained market share in respect of Richmond, and that leads me to one final point, which is this, and it's really a point I started with yesterday or

mentioned at an early stage: the period we are talking about was a period of intense competition between Imperial and Gallaher. That period of intense competition is evidenced by the strategy documents which we set out at section 2 of our reply. I invite you to look at those. You will see that they are set out in section 2, they directly contradict the OFT's contention that the purpose of what was going on was to seek stability rather than competitive advantage. It's self-evident when you look at those documents that Imperial, for its part, was seeking to compete and to reduce the prices in order to gain market advantage.

So we say that the OFT's case, even before you come to hear from Mr Brealey on the correct legal approach, is utterly misconceived.

THE CHAIRMAN: Yes, thank you very much, Mr Howard, that's been very helpful.

So now are we moving to hear from you, Ms Rose?

MS ROSE: Yes.

Opening submissions by MS ROSE

MS ROSE: There is a famous scene in Ken Loach's classic movie "Kes", which I am sure the Tribunal will recall is set in a grim northern boys' school, in which a boy is sent with a message to the headmaster and he is told to go and find him in his study, and he gets outside the

headmaster's study and there is a group of other boys waiting to go in and it turns out they are all waiting to be caned. They go into the headmaster's study and this boy tries to explain that he is not in the same situation as them, he has been sent to the headmaster and the headmaster tells him to shut up and canes him anyway.

That's a bit how Shell feels about this case, because Shell has been found to be a party to infringing agreements under which it is said to have agreed with the tobacco manufacturers to set the retail prices from tobacco products in order to achieve the parity and differential requirements between competing brands set by those manufacturers. In making those findings, the OFT has treated Shell in exactly the same way as all of the retailers, people like Somerfield, Asda, Co-op, all the other parties that you see in court. Indeed, you will see in the OFT's decision that Shell is defined as a retailer, and described as a retailer, and part of the generic group of tobacco retailers.

Indeed, it goes further than that, because, as we shall see in a little while, the critical paragraphs of the OFT's decision in section 6 of the decision, where the OFT actually finds the participation in the infringing agreement, have simply been cut and pasted and applied to Shell in verbally identical terms to the terms in which they are applied to the other retailers, simply with the insertion of different gobbets of evidence.

But Shell's situation was fundamentally different from the situation of the tobacco retailers. For the whole of the period of the alleged infringing agreement between Shell and Gallaher and for the vast majority of the period of the agreement between Shell and ITL, Shell was not in fact retailing tobacco products, and Shell was not in a position to set the retail price of tobacco products.

The filling station sites which are owned by Shell, which include of course the convenience stores, the Shell Select stores that you will all be familiar with which sell a range of products, including tobacco, were and are operated by independent contractors in accordance with a retail business agreement or RBA, between the contractor and Shell. We are going to look at that agreement in some detail shortly.

The introduction of the RBA between October 2000 and August 2001 was a major commercial restructuring for Shell, undertaken -- as we shall see in a moment -- because Shell was concerned about the underperformance of its filling station sites, it was concerned that they

were not sufficiently profitable and that the reason was that there was not enough autonomy and entrepreneurial spirit being operated by the filling station managers.

The solution, therefore, was to give to those filling station managers a new role as an independent contractor where they had responsibility for the conduct of the business within parameters set by Shell, selling a core range of products that were required by Shell as well as their own locally selected products, and with autonomy over the retail price that they were to charge for those products, subject only to a maximum price, the maximum price being set at a level that Shell would have considered to be truly excessive, sometimes referred to in the evidence as an "insult price", so it's a price above which there would be a risk of alienating your customer base.

This was a major commercial undertaking for Shell. It involved, over a period of about nine months, wholly restructuring hundreds of sites, and we will see the evidence about that in a moment.

Crucially, as I've just said, under that agreement, Shell is not entitled to set the retail price. It can recommend a retail price and it can set a maximum price, but the retailers, the contractors, not Shell, are free to sell tobacco products at any price above or below the

recommended retail price, any price up to the maximum.

The OFT's case against Shell is founded essentially upon trading agreements entered into between Shell and the tobacco manufacturers and contact between Shell and the manufacturers.

The main preoccupation of those agreements and indeed of the relationship between Shell and the manufacturers related to the distribution and display of tobacco products, because, as you heard yesterday from Mr Howard, it's not permitted to advertise tobacco, and therefore the display of tobacco products has become the last means by which -- and not for very long, unless we win -- the tobacco manufacturers are able to market their product at point have sale. You have a gantry that's branded and the display of the products in the gantry and their positioning in the gantry is crucial for the marketing of those products. And the availability of the products is also of course crucial for manufacturers.

As we shall see, that is the main preoccupation of the trading agreements between Shell and the manufacturers, and it is questions of what are called the planograms, which are -- the diagrams show where the different products are, but the planograms are the area where the majority of bonus is earned.

You will also see that Shell did have the power under the RBA to require its sites to comply with the planograms. The planograms were enforceable. You will see in some of the evidence references to compliance, compliance with the plan. That is not talking about pricing, it is talking about the arrangement and the distribution of cigarettes in the planogram.

The trading agreements also offered very modest bonuses to Shell, if Shell maintained specified price differentials and price parities between particular competing brands and these are the provisions in the trading agreements on which the OFT relies.

Now, we will look in a moment at the agreements because I am told I am not allowed to say out loud the size of the bonus between Shell and ITL. The Tribunal may have picked it up. It is absolutely minuscule in relation to the size of Shell's business.

Stepping back from this case for one moment, the proposition that for that sum of money, ITL purchased from Shell the right to set all of Shell's retail prices across the United Kingdom is quite a surprising proposition.

When you read those trading agreements in their proper context and in terms of the factual matrix which of course crucially includes the RBA, what is apparent is that the most that Shell is agreeing to do is to include the parities and differentials in its price files. The price files are the documents that recommend to the contractors a recommended retail price and a maximum price, and crucially that is not the setting of a retail price. Indeed, as the Tribunal will immediately have realised, that of course is the type of provision that is specifically permitted under the Block Exemption, because that is simply the recommendation of a retail price or the setting of a maximum retail price.

We submit that it is obvious that Shell did not agree to fix the actual shelf retail prices at its sites in any agreement with ITL or Gallaher. Shell was simply not in a position to perform any such agreement. Had it sought to impose fixed retail prices on its own independent contractors, it would immediately have been liable to an action for breach of contract, and there is no adequate response from the OFT to this obvious fact. I am going to come in a moment to what the OFT have actually said, and it is in our submission wholly inadequate.

Indeed, it goes further than that, because the tobacco manufacturers could not possibly have understood that Shell was agreeing to set fixed retail prices,

leaving aside the fact that they were perfectly well aware of the existence of the RBA and of the structure of Shell's business. The price files themselves, as we shall see, were documents which passed regularly between Shell and the tobacco manufacturers and about which there was considerable discussion between Shell and the tobacco manufacturers.

It is clear on the face of those documents that they are not setting a retail price, because they contain two prices, a recommended retail price and a maximum retail price, and therefore any agreement whereby Shell agreed to reflect differentials and parities in a recommended retail price and a maximum retail price could not possibly result in the maintenance of those parities or differentials in shelf retail prices. This is obvious.

If you pass to the retailer a document that says, for example, Lambert & Butler between £3.80, and £4, recommended retail price £3.80, maximum £4, Benson & Hedges recommended retail price £3.80, £4, it is quite obvious that the retailer is not obliged to maintain a parity between Benson & Hedges and Lambert & Butler, because even on the face of the document itself there is a range between the prices, and we know that in fact under the RBA the recommended retail price wasn't a floor, it was what it says, it was a recommendation.

If this is the correct analysis of Shell's agreement with the tobacco manufacturers, and we say that it quite obviously is when you look at those agreements in proper context, then the OFT's case against Shell, which is predicated on a finding of fact that Shell was a party to agreements to fix the retail prices of tobacco products fails. The OFT has simply never investigated, much less made any finding, as to whether or not an agreement by Shell to recommend to its contractors prices within a range reflecting parities and differentials between brands could constitute any infringement by object. One thing is certain, having heard Mr Howard's very clear exposition of the theory of harm, it certainly does not extend to any such situation.

We say the case in fact goes even further than that, because we say it is clear from the evidence that in fact Shell did not consider itself even to be constrained by the trading agreements to incorporate the differentials and parities in its price file. The position was that Shell understood that if it did do that there would be a very small incentive, the bonus, that would be provided as a result. But the bonus was so small that it didn't operate as a significant factor, and Shell in fact considered a range of factors when

deciding how to position recommended retail prices and maximum prices on the price files. Most obviously it was concerned to ensure that its recommended retail prices were set at a level that would permit a reasonable margin to its independent contractors because it was, after all, making a recommendation to them.

The OFT has made much play in its decision and in its skeleton argument of the documents which show contacts between Shell employees and employees of the tobacco manufacturers where the manufacturers propose that the price files should be amended in particular ways to bring them into line with parities and differentials. We shall show in due course that in fact Shell frequently did not comply with those suggestions.

But more fundamentally, even if the OFT was able to prove that Shell always complied with the requests and that all Shell's price files reflected the manufacturers' preferred differentials and parities, the OFT's case would still fail because those price files did not set the retail price for tobacco in Shell's service stations.

What is striking is that the OFT has not produced any evidence at all that Shell, on any single occasion, instructed any of its contractors in any single filling station to alter a retail price in order to comply with the parities and differentials on the price file. There is no record of Shell ever having done that. As I've said before, it's not surprising because if Shell had tried to do that, the contractor would have simply told them where to go and pointed out very politely that they were in breach of the RBA.

With those introductory comments I would like to make two very short legal points and then to consider Shell's relationship with each of the manufacturers, and then the flaws in the OFT's argument.

Turning to the legal framework, I do not intend to make substantial submissions on law, I understand you are going to get that from Mr Brealey on Monday, but there are just two short points I want to make.

Can I invite you to turn to the Irish Beef case, authorities bundle 3, tab 47. {A3/47} If we just go to paragraph 14, the issue in this case was what had to be shown in order to establish an object infringement, and we see the question at paragraph 14:

"The national court asks whether agreements with features such as those with BIDS arrangements are to be regarded by reason of their object alone as being anticompetitive and prohibited by article 81(1) or whether it's necessary first to demonstrate that they

have had anticompetitive effects.

"It must be recalled that to come within the prohibition laid down in Article 81(1), an agreement must have as its object or effect prevention, restriction, distortion of competition in the Common Market. It has, since the judgment in LTN, been settled case law that the alternative nature of that requirement indicated by the conjunction or leads first to the need to consider the precise purpose of the agreement in the economic context in which it has to be applied. When, however, an analysis of the clauses of that agreement does not reveal the effect on competition to be sufficiently deleterious, its consequences should then be considered."

First of all you are directed to consider the precise terms of the agreement in question. Then at 16, again we are told:

"... no need to take account of its effect once it appears its object is to prevent, restrict or distort competition. That examination must be made in the light of the agreement's content and economic context."

Then at paragraph 17 there is the point that:

"The distinction between object and effects arises from the fact that certain forms of conclusion by their very nature are injurious to the proper functioning of

normal competition."

Then at paragraph 21:

"To determine whether an agreement comes within the prohibition at 81.1, close regard must be paid to the wording of its provisions and to the objectives which it is intended to attain."

The point that I want to make is to stress that the ECJ makes in those paragraphs on the importance of a proper analysis of the terms of the agreement, and with great respect to the OFT it is a striking feature of this case that its analysis of the actual nature of the agreements between Shell and the tobacco manufacturers is strikingly inadequate.

You will also note that it is the precise terms of the individual agreement that must be considered. It is not good enough for the regulator to identify a generic template of an infringing agreement and then simply to seek to shoehorn into that template the different facts of different particular parties.

The second short legal point I want to make is in relation to the GlaxoSmithKline case, that's in authorities bundle 2, tab 36, paragraph 77 {A2/36 paragraph 77}. This passage is common ground and is indeed relied upon by the OFT itself in its decision, if I could just give you the reference it's paragraphs 3.29

to 3.30 of the OFT's decision, this same passage is relied on.

Paragraph 76, first of all, you can see the heading "Concurrence of Wills" so this is how you determine whether a particular party is a participant in the agreement in question:

"In order for there to be an agreement, it is sufficient that at least two undertakings have expressed their joint intention to conduct themselves on the market in a specific way.

"While it is therefore essential that the decisions in which the Commission applies Article 81(1) show the existence of a joint intention to act on the market in a specific way, those decisions, contrary to GSK 's contention, are not required to establish the existence of a joint intention to pursue an anticompetitive aim."

So it has to be shown that Shell, not ITL, not Gallaher, that Shell was itself intending to act on the market in a specific way. In the context of this case, that means that the OFT has to establish that Shell was intending to set the retail prices, and I stress set the retail prices, for tobacco products in accordance with the priorities and differentials on the price file. Unless it can be shown that Shell itself had that intention, then it was not a party to any infringing agreement.

DR SCOTT: Just to be precise there, you talked about it a little earlier on, at 110/24, you talked about fixing prices.

MS ROSE: Yes.

DR SCOTT: As I understand it, the allegation is not an allegation of fixing prices, but of fixing parities or differentials.

MS ROSE: We shall see in a moment exactly what the OFT found. In fact, we can turn to it next, and I think it will answer your question, sir. If we can take up the OFT decision, if you turn to paragraph 6.1173, this is the summary of the finding in relation to participation in an infringing agreement by Shell. Page 375. ITL and Shell, it's said:

"... were party to an agreement or concerted practice whereby ITL co-ordinated with Shell the setting [and I stress the word 'setting'] of Shell's retail prices for tobacco products in order to achieve the parity and differential requirements between competing linked brands that were set by ITL in the pursuit of ITL's retail pricing strategy."

The finding of the infringing agreement depends on Shell having agreed to set the retail price. That's why I say really the case against Shell just doesn't get off

the ground, because not only did Shell not intend at any stage to set a retail price, it had no power to do so.

That's the specific findings in relation to Shell. We can see how that fits in to the overall findings if we go back to the beginning of section 6 of this decision, page 77.

First of all you can see that the heading of section 6 is "Analysis of the Infringing Agreements" and there is an overview:

"The salient factual elements of the infringing agreements are set out below in the sections of this decision evidencing each bilateral vertical infringement agreement. The evidence demonstrates that under the infringing agreements each manufacturer co-ordinated with each retailer the setting of the retailer's retail prices for tobacco products", et cetera.

You can see that the formula that's used there is exactly the same as the formula that's used at 6.1173. In fact, if you look through section 6 you will see that there is a section for each retailer and that in relation to each retailer the key term of the infringing agreement is expressed in identical wording. That's why I make the submission that in fact what the OFT was obliged to do, to establish a case against Shell, was to examine Shell's individual agreement in accordance with

its own facts in its own factual matrix in its own legal and economic context and look at its own precise terms.

What unfortunately the OFT appears to have done is to have developed a platonic ideal of an infringing agreement and then to seek to force Shell's facts to comply with that, rather in the way of the original Cinderella story where the ugly sisters' toes were cut off so they would fit into the slipper. We submit that is inadequate.

If you compare the section of section 6 that deals with Shell with the equivalent sections that deal with the other retailers, you will see whole paragraphs and chunks of text simply lifted and cut and pasted into the section.

There is another striking feature of section 6, and that is there is no analysis at all in section 6 of the RBA, and the question of whether Shell was a party to an infringing agreement is decided in section 6 without reference to the existence or terms of the RBA.

As we shall see, rather oddly, the OFT comes on to consider the RBA in section 7 of its decision after it's already reached the conclusion that Shell was a party to an infringing agreement.

So with that look at the decision of the OFT, can we now turn to the RBA, because we submit that it simply is

not possible to understand the relationship between Shell and the tobacco manufacturers or the agreements between Shell and the tobacco manufacturers without understanding the factual context into which those agreements were entered into, and that included in particular the very significant changes that Shell was making to the structure of its business at this time.

Can we turn first to Mr Moss' evidence, core bundle 11, tab 117. {C11/117} David Moss was at the material time the UK retail sales and operations manager of Shell, and you can see that at paragraph 8 of his witness statement. If you read paragraphs 10 and 11, he explains the decision, the situation in 1999 and the discussion within Shell as to whether it was appropriate, both in the UK and at a global level, to maintain the direct management model, and the prevailing view was that it was unsustainable, a major factor in the poor performance of the UK petrol stations.

Then he explains that the RBA model was formulated between August 1999 and January 2000 and that its structure was agreed by the first quarter of 2000 necessary legal documents, and then he explains its implementation.

Then paragraphs 12 down to 18, he explains the strategy and that Shell had identified the problem that, even though it was very good at selling motor fuel, it wasn't so good at convenience retailing, not surprisingly, and the best way to deal with that problem was to enable retailers to optimise the convenience retailing business stream. That's at paragraph 12.

Expectation that moving to the RBA would result in better management of the convenience retailing. Retailers would have both more freedom to innovate, drive sales and control costs, and also more incentive to do so because they were going to share in the profits of the retailer.

Then there is an explanation of precisely what a major overhaul this was, that a lot of the existing managers, they all had to be reinterviewed and a number didn't make it because they didn't have the necessary entrepreneurial skills, it was a very different role than that which had applied in the original service stations.

Then at paragraphs 19 down to 23 he describes how the RBA works, and he calls it a fundamental change to how Shell's UK retail petrol station business was run. It gave autonomy to the retailers in how they ran their business, which included the convenience store element. The principle was Shell would only retain ownership and control of certain aspects of the business such as the

wet stock -- that's essentially motor fuel -- price over the wet stock, land, health and safety standards and operation standards of the forecourt.

Then:

"The retailer was to be an independent businessperson who had invested in the business and would have ownership and control of the dry stock (non-fuel stock such as convenience goods) and the employees. In short, the RBA contractors would be acting as agent for Shell in selling the fuel and acting on their own account in convenience retailing but paying a commission to Shell in respect of the same."

Then at 22:

"Although business control was given to the RBA contractors, Shell wished to try and maintain some consistency across the shops in terms of standards, at least so as to protect the Shell brand. As such, Shell required particular core products to be stocked, approximately 90 per cent of the total, specified how they should be displayed. It also recommended a retail price for each product and stipulated a maximum price to ensure that overpriced merchandise at one location would not reflect badly on the Shell brand in the eyes of customers.

"Shell would not, and under the RBA could not, have

dictated the actual price the product should be sold at beyond requiring the RBA contractors to remain below the maximum price.

"I am not aware of any occasion on which Shell told RBA contractors what to do with their dry stock other than in compliance with the principle in the RBA and discussed above. I am aware of no example of Shell telling RBA contractors what price to use beyond provided recommended and maximum prices."

He says he thinks he would have known if it had happened.

DR SCOTT: Just a small technical point, in fact if I came into a Shell store, because of the flash trading, I am actually contracting with Shell, aren't I?

MS ROSE: That's correct, we will see that in the RBA itself, that what happens at the point of sale is that the contractor sells the cigarettes to Shell and Shell sells them to you. He explains that at paragraph 31, and he explains the reasons for it. It's essentially because otherwise you would have had to have two VAT numbers, separate VAT receipts, and it would have been wholly unworkable and very irritating for the person who wanted a tank of petrol and 20 cigarettes, so it was purely a mechanism. But Shell had no control at all over the terms of the sale, it was the contractor who

agreed the price and essentially was the retailer in substance.

Then the success of the RBA is described at paragraphs 35 to 37, basically it has done what was hoped of it and still in use in the UK and has been adopted elsewhere in the world.

So this was a major undertaking for Shell, and the terms of the RBA itself can be seen, if you take volume 2 of Shell's notice of appeal, at tab 34.

Behind tab 34 it should say annex E. There is Mr Conrad's witness statement and if you go to tab 1 behind that you should have the RBA.

DR SCOTT: There is volume 2 --

MS ROSE: Volume 2, tab 34, then do you see annex E.

DR SCOTT: Tab 34 I have as National Grid v Ofgem.

MS ROSE: If you go a little way beyond it, you see annex E and 1, and if you go to the 1, that should be exhibit AC1, which is the RBA.

THE CHAIRMAN: Right.

MS ROSE: If you look at clause 1 that deals with the appointment of the retailer. You will notice immediately that retailer here doesn't refer to Shell, retailer refers to the independent contractor. At clause 1, without going through it in detail, you see the parameters of the business that's to be operated by the retailer.

Then at clause 2, the aims and objectives of the agreement, and you will see that the two bottom bullet points include engaging in the business at the site and enhancing and retaining Shell's reputation on the profitability of the site to the benefit of both parties.

Then clause 3 deals with motor fuels, clause 4 with the car wash and car vacuum, and clause 5, the shop and sale of what are called NFR goods, which means basically everything except fuel. If you look in the glossary at the front of the screen, you will see NFR is essentially defined as anything that's not motor fuel.

"The retailer will carry out the business of a sale of goods and services through the shop at the site in accordance with the manuals and purchase of his own account all NFR goods for sale through the shop at the site."

So the retailer buys the cigarettes himself.

"NFR goods consist of two types: core range and local range. The core range [and this includes the cigarettes on the price files we need to be concerned with] can only be purchased from the Shell distribution system or any other supplier approved by Shell."

So there is a Shell approved supplier who provides

the core range. Then:

"Pricing of NFR Goods" is clause 5.6.

"The retailer will determine the retail price at which the retailer will sell all NFR goods as follows. In respect of core range, Shell will set out in the manuals recommended retail prices and maximum retail prices. These shall not amount to fixed or minimum retail prices and the retailer will be entitled to set the retail prices at any amount up to and including the relevant maximum retail price. The maximum retail prices will be set at levels above which prices would be considered excessive and without justification. The existence of the maximum retail prices is not intended to limit the retailer's real commercial freedom."

We submit that that clause really could not be any clearer, and that it's a fundamental part of the successful operation of this whole commercial enterprise, because the whole point of the new system is to give the contractors autonomy to run their own businesses, so that in a particular locality they will be sensitive to the local competition about price levels and they will be able to judge what's the appropriate competitive prices to charge for particular products, and they might decide for example that particular products are very attractive and a good way of getting

footfall and therefore be prepared to cut their margin on particular products to get people in to buy fuel or other products, and the whole point of this system is that Shell had concluded that a system where Shell was centrally setting prices for the whole of the UK just wasn't working and you needed to give these people the ability to run their own business.

The whole of the OFT's case is inconsistent with this business model, because as we have just seen the OFT has made a finding that Shell intended, by its agreements with the tobacco manufacturers, to set the retail price for these petrol stations in a way that would not only have been a breach of Shell's own freshly minted RBA, but inconsistent with its whole commercial purpose.

When you weigh up for Shell the economic implications of its whole new commercial model enshrined in the RBA against the size of the bonus that was being offered by the tobacco manufacturers, we say that this case just departs from reality.

THE CHAIRMAN: Would you say it would have been a breach of the RBA for Shell to say to the retailer: look, this is the recommended retail price, this is the maximum price of all these different tobacco products, we don't mind where within that range you choose to set your price,

but please be aware that we would like you to set whatever price you choose, there has to be this 3p difference between the Lambert & Butler or Benson & Hedges.

MS ROSE: Yes, ma'am, that would have clearly been a breach of 5.6 because 5.6 says:

"The retailer will be entitled to set the retail prices at any amount up to and including the relevant maximum retail price."

So Shell, it would have been a clear breach of that clause for Shell to seek to impose relativities, even if it was not seeking to fix the absolute price, it would have been a clear breach of this agreement.

Not surprisingly there is no evidence at all that Shell ever sought to do that. The OFT doesn't even point to any evidence that it says potentially shows Shell trying to do that.

You can see, by the way, the flash sale point, that's clause 5.7, that deals with the flash sale, and it's made clear that it's still at the price depended upon by the retailer as set out in clause 5.6.

Contrast the freedom that is given to the retailer to set the retail price with the question of NFR goods and layout. This is clause 5.11.

"The retailer must merchandise NFR goods in accordance with store layout plans provided by Shell allowing for the insertion of the local range and planograms provided by Shell for each category of the core range. Local range will not be represented in the planograms."

That's why I made the submission earlier that there is a key distinction to be drawn between Shell's role in relation to the stocking of cigarettes and the planograms for their display and Shell's role in relation to pricing of cigarettes, because Shell was entitled under this agreement to require shops to stock particular brands and to display them in particular layouts, and so that was indeed an issue about the compliance of local stores, but Shell was not entitled to require particular retail prices or even particular relativities of retail prices.

5.19, promotions:

"The retailer will, as set out in the manuals, comply with Shell's requirements in respect of promotions relating to motor fuel and comply with Shell's requirements in respect of all other promotions should the retailer choose to take part in them."

So again you see a distinction between motor fuel where they have to comply with Shell promotions and other types of promotions which would include tobacco

products where they have a choice whether to participate in the promotion, but if they do, they must participate in the promotion in accordance with its terms.

Then clause 6 deals with the operation of the business, that needn't concern us. Fees and method of payment is at clause 8 and in short what it comes down to is a royalty payment, a percentage of sales. Then breach and termination. There is a yellow card/red card system where you get a warning, and a breach warning notice, it's at 9.2, and the matters for which you get one include, the third bullet:

"More than ten core range items priced above maximum retail price during any three month period."

Four bullets from the end:

"Stocking of NFR goods contrary to Shell's instructions", clause 5.5."

So there you can see again the precise ambit of Shell's ability to control, maximum retail price, stocking requirements.

Then the final point to note at page 227, article 11, 11.2 is an entire agreement clause.

MR SUMMERS: May I just ask a question about the planograms?

MS ROSE: Yes.

MR SUMMERS: I don't see any reference here to the provision of gantries, and yet actually a planogram would seem to

me to be dependent upon the particular style of gantry that was going to be used. Was that dictated by Shell in agreement with the manufacturers to which gantry was going to be used, or was that up to the individual retailer to select a gantry?

MS ROSE: It's certainly not covered in the ITL agreement. When we look at the Gallaher agreement we can see if it specifically refers to the gantry, I can't remember off the top of my head. The facts were that there is a certain amount of evidence that shows that ITL certainly was exercised about the fact that Shell had purchased a large quantity of particular gantries that ITL wasn't particularly happy about, and we see there is a certain amount of argy-bargy over the question of the gantries.

In terms of this agreement, of course one of the matters that Shell has the right to dictate under the agreement is the layout of the shop, so that would include the display of the cigarettes in the gantry.

DR SCOTT: Just two points. One, you mentioned the entire agreement.

MS ROSE: Yes.

DR SCOTT: But you have already mentioned the concept of requirements, some being mandatory requirements and some being non-mandatory requirements which appear not to be

rehearsed in the entire agreement, if you see what I mean. That's one point.

The other is just to clarify in my own mind, my recollection is that with Imperial, one of the alleged agreements takes place before you start on the RBA --

MS ROSE: I will come on to the trading agreements themselves.

DR SCOTT: I am just getting clear in my mind the juxtaposition.

MS ROSE: The timing goes like this: the beginning of the implementation of the RBA is October 2000, the first ITL agreement is with effect from January 2001, during the transitional period. We will explore that in a moment. That's for one year. There is then a second agreement with ITL with effect from January 2002.

The agreement with Gallaher is negotiated in November 2001. So the Gallaher agreement post-dates the full implementation of the RBA. The first ITL agreement occurs during the transitional period.

Just so we can get a picture of the way that the RBA was coming in, if we can just take up the notice of appeal, bundle 2 again, there is a useful graphic.

THE CHAIRMAN: I do not want to stop you in mid-sentence, but I think we need to break if only for five minutes.

MS ROSE: Yes. I don't know if you are able to sit a little late.

THE CHAIRMAN: I know you want to get finished. I think probably we would rather --

MS ROSE: Can I just say this: in the same bundle that we are in, if you go to page 467, this shows you the transition between the Shell operated sites and the independent retailer operated sites, so that as you can see it starts with a pilot in October 2000. If you look, January 2001, that's the date of the first ITL agreement, and by that time there are 195 independent retailer sites and 438 Shell operated sites. The infringement is taken by the OFT to have commenced in March 2001, and you can see that by that date the majority of the sites are independent retailer operated. There is 328 versus 306.

The following month there are twice as many independent retailer sites as Shell sites. By May, three times as many, only a quarter of the sites by this time are Shell operated, and by June, the number of Shell operated sites is de minimis.

That's perhaps a convenient moment.

THE CHAIRMAN: Yes, thanks very much. We will come back at 20 to 4 then.

(3.30 pm)

(A short break)

(3.40 pm)

THE CHAIRMAN: Just a quick word before we restart. Mr Brealey, you may want to be thinking whether there is anything that you can tell us at the end of proceedings today that might be useful homework for us to do which might enable you to shorten things on Monday morning as far as reading authorities is concerned.

MR BREALEY: I will, thank you.

THE CHAIRMAN: Yes, Ms Rose.

MS ROSE: Can I now turn to the particular trading agreements, and first of all to the agreement between Shell and ITL.

If we stay in volume 2 notice of appeal bundle, and these tabs are not the easiest, we are behind annex F, page 479, the actual tab is numbered 6 but that doesn't help you much, it's page 479.

This is of course trite law that a contract must be construed in its factual context and the factual context in which this contract is being signed is a situation in which the introduction of the RBA, as we have just seen, is already well advanced and is a significant change in the commercial arrangement of Shell.

There are three headings on the page. The first point to note is this is a very primitive agreement. It's some way lower down the evolutionary tree than the

RBA, and it's clearly a piece of commercial shorthand. That may reflect the relative commercial importance for Shell of this agreement versus the RBA. It also reflects, of course, the way in which it's to be construed, that it's not to be taken as if it were a statute. It's an informal commercial agreement and it looks unlikely that it ever saw a lawyer. Not necessarily a bad thing of course.

The first heading is "Prices":

"In return for Shell UK setting the selling out prices at company owned sites reflecting ITL products, no worse than the relative RRP compared to other manufacturers' similar products, an annual payment [and there you see the size of the bonus] A detailed list of these requirements is as attached. Copy price lists must be provided. Any errors corrected within two weeks of notification to head office. ITL must be given the opportunity to respond to other manufacturers' price offers but may choose not to respond. At least 95 per cent of company owned sites must follow the official Select price policy guidelines."

A number of points to make. The first is the minuscule size of the incentive that's being provided to Shell. I do submit that in the context of a company of the scale of Shell, this is a fleabite, it's really of

no significance whatsoever. If you therefore just take the agreement on its face, and ask: is this in any sense a significant constraint on Shell's commercial behaviour?, the answer is obviously no. If Shell decides that it's in its interest to set recommended retail prices or even fixed retail prices for those sites still under its control, that it's in its interest to do that at a particular level with different differentials from those which ITL is advancing, it's not going to be deterred from doing that by the anxiety that this huge bonus is going to be forfeit.

That, we say, destroys the OFT's case put at its highest, and indeed when you look at the evidence which we are going to hear from the factual witnesses, in particular from Annie Parker, who was the category manager, we will hear from the witnesses that Shell didn't take proposals from ITL or Gallaher as being instructions, they were suggestions, and Shell would consider them, consider other matters such as margins, and decide on the basis of its own interests whether to accept them or not.

The second point is that the focus of this agreement is price lists, and by this date the price lists that were being produced were the price files which contained two prices, a recommended retail price and a maximum retail price. What appears to have been the position at this transitional period was that those sites operating under the old arrangement would be expected to sell at the RRP, although even in relation to those sites there was some flexibility about pricing depending on local conditions, but those sites which were already under the RBA were only required to price below the maximum retail price.

Then the third paragraph:

"At least 95 per cent must follow the official Select price policy guidelines."

Of course you have to ask the question: what are the official Select price policy guidelines? They are certainly not defined in this very informal agreement. In my submission, what they are is what I've just said to you, that in relation to sites that are not under the RBA, they mean they are expected to sell at the RRP unless there is a good local reason why not, and in respect of other sites it simply means below the MRP.

Then you see the next heading "Range", and this is dealing with planograms and distribution, and I note that it's marked as confidential, so I just ask you to read that. You can see the -- it's still a modest bonus -- relative size of that bonus by comparison with the pricing bonus, which is an indication of the

relative importance from the perspective of ITL of this clause as compared to the first one.

So that's the 2001 agreement entered into in the transitional period.

The following year there is a second ITL trading agreement, which you will find at the next tab, page 483. By this date, transition to the RBA is complete. If you keep both tabs open for a moment and look at the first sentence you will see an interesting difference. The first one says:

"In return for Shell UK setting the selling out prices at company owned sites."

The second one says:

"In return for Shell UK setting out prices at company owned sites reflecting ITL products" and so forth.

Now, I would suggest that what that is reflecting is that by this date, both parties know that Shell doesn't have any power to set the selling out prices at its sites, the only power that it has is to set out prices in the price file in accordance with the price file format.

Then you will see the second paragraph now refers to price files, and you will see that the third paragraph, the one referring to 95 per cent of sites, has gone

completely. So we submit that you can see some small but not insignificant amendments made to the price clause which reflect the fact that both parties now understand that there are no more directly Shell owned sites, there are only sites operating under the RBA, and that Shell no longer has the power to set the retail price.

We can see how the OFT deals with these two agreements, if you take up the decision and go to page 378, you will see the heading "Trading Agreements Between ITL and Shell".

Just one general point, which is that I will be generally referring to the decision of the OFT. The OFT has sought, with great respect to it, to elaborate upon or improve its case in its defence and skeleton argument. Those are of no concern to the Tribunal because the OFT's obligation was to set out its reasoning and make its findings of fact and explain its analysis in its decision, and that's the matter that's under appeal.

So we go to paragraph 6.1186. That's another cut and paste paragraph. Then 1187 identifies the two trading agreements.

1188 says:

"Under the terms of TA1 [that's the first agreement]

and TA2, ITL and Shell agree the following."

What you will see there is a misquote, because what you actually have there is a strange hybrid. The first paragraph appears in TA1 but not TA2, and it's the reference to setting the selling out prices which isn't in TA2 at all, and the second, the reference to the price files, is in TA2, not TA1.

So that doesn't giver one perhaps enormous confidence that the OFT has examined this contract with the precision that the ECJ requires as essential in the Irish Beef case.

Then it says:

"In addition, TA1 stated at least 95 per cent of company owned sites must follow the official Select price policy guidelines."

You will note that there is no consideration at all by the OFT of what that meant in this transitional period, and you will also note that there is a footnote, 997:

"This provision does not appear in TA2."

Again, no consideration on the part of the OFT of the significance of that fact. So we submit that in fact all the significant indicators in these agreements and most particularly in the second agreement demonstrating the parties' mutual understanding of the limits of Shell's powers to set any retail prices are simply ignored or not analysed or misunderstood by the OFT.

Now, the price file that's referred to, just to show you an example, if we go back to volume 2 of the appeal bundle, you can see an example at page 523, there are lots of these, but this is an example from October 2001, "Shell product master file list for RBA sites". You can see that you have the barcode product description, Shell stock code, main group supplier, supplier code, Shell invoice cost, pack size, and then recommended retail price and maximum retail price, and that's the standard format for all the prices. We submit that nobody reading that could understand that Shell was setting the retail price. It is clearly not, we would say.

THE CHAIRMAN: What's the significance of some of them being underlined?

MS ROSE: That relates to particular matters in the witness statement to which this relates. We will deal with that later, but it's not relevant to the point that I am making.

Now, as a matter of fact, we know what ITL understood the position to be. If you take up annex 19 to the statement of objections, thereby a number of internal ITL documents where they summarise their

understanding of the development of Shell's new commercial structure. The first of these is at document 30. The whole of this is confidential, which makes it slightly difficult to make submissions on it.

This is page 199, tab 30, you will note the date on this, this is March 2001. This is the beginning of the infringement period, in the OFT's decision. You see the heading "Background", and can I invite you to read the first paragraph under that heading.

(Pause)

I am told I can read out part of this paragraph. It's marked non-confidential in Mr Howard's but confidential in mine.

"The key point is that there is an explanation of the transitional period. 700 of the sites are company owned, all traders Select, the remaining 500 are dealer sites over whom Shell have no control regarding the shop. Shell directly manage around 300 Select shops. The balance of the Select sites [so it's already a majority] are run by self-employed agents who own the shop stock but are given strong guidance by Shell with regard prices, range, source of supply and display but he/she makes the final decision.

"Current agent agreement was introduced in the last 12 months, has given operators a higher share of the

profit, plan is to reduce the managed site numbers dramatically but the target number is not known."

So as at March 2001 ITL clearly are aware of the fact that the decision on price is made by the agent not by Shell, the way they put it is that Shell can give strong guidance, but they understand that Shell cannot make the decision, the decision is made by the agent.

So there is simply no belief by ITL that Shell is in a position to set differentials or parities in relation to retail prices, they know they can't. They can suggest it, they can recommend it, but they cannot impose it.

Then towards the bottom "Target differentials are achieved on all products most of the time", and then over the page, you will note under the heading "Problem", item 2:

"Price differentials not achieved at some agents' sites, and occasionally errors from head office."

So again an understanding that they can not achieve the price differentials at some agent sites because there is no power to impose.

So that's in, as it were, the early days, during the transitional period.

Then if you go forward, the following year, in the same file, tab 44 --

THE CHAIRMAN: That does seem to assume that the desired price differentials are somehow being communicated to the agents.

MS ROSE: Yes.

THE CHAIRMAN: Which doesn't appear in the price files that you have shown us or in the RBA.

MS ROSE: The price files communicate a recommended price and a maximum price. The only way that the differentials or parities are communicated to the agents is in the sense that the recommended retail price, let's say if there are two products where there is expected to be a parity, you would expect the recommended retail price and the maximum retail price for those products both to be set at the same level. That's the only way that it's communicated to the agents by Shell. It's up to the agent whether they price both at the recommended price, both at the maximum price, one at maximum, one below recommended retail, both somewhere in the middle. They have absolute discretion to do that. All that's being communicated to them is the parameter, and ITL understand that.

DR SCOTT: And are sending round their staff --

MS ROSE: To persuade them to do it. Absolutely, sir, and we see in the evidence that both ITL and Gallaher understand that the people they have to talk to are not

Shell, they are the guys running the petrol stations. So what you see them doing is going round to the individual sites and trying to persuade people to price in accordance with their differentials. The reason that they are doing that is that they know that Shell is not doing that, has no intention of doing that, and has no power to do that. There is nothing to stop a manufacturer seeking to persuade a particular retailer to sell at a particular price, and more fundamentally of course that has nothing whatsoever to do with any infringement on the part of Shell. But the very fact that they are doing that shows that they understand that Shell can't do it.

So that's in the transitional period. The following year, tab 44, so this is January 2002, again this is marked "confidential" but not in our -- good. So here we have a description of the situation now, second paragraph:

"Before 1999, Shell had approximately 715 Select sites. The latter part of 1999, announced the whole of the sites to be transferred to Texaco" and so forth.

"Up until two years ago, Select sites were run by Shell employed managers. However, a new scheme was introduced that has reduced the number of direct managed sites to nearly zero."

Actually it was zero by this stage.

"Shell Select sites are now run by self-employed agents. Agents own all shop stock but are given guidance ..."

Note the word "strong" has now gone, so ITL now understand that it's simply guidance.

" ... given guidance by Shell with regard to range, merchandising, pricing and source of supply. Ultimately the final decision is that of the agent. The RBA is aimed to provide the agents with a higher share of the shop profits", and so on.

Then at 209, just below the second holepunch:

"Shell recommends a pricing policy to all Select sites. The price file consists of a Shell recommended price and a maximum price for each product. A copy of the price files provided to ITL. In the main, differentials between manufacturers' comparable brands are maintained, however, since the changeover of category managers some shoulder brands such as Superkings Lights are showing incorrect differentials."

In my submission, that accurately represents what's actually going on as between Shell and ITL. What's happening is that ITL is seeking to persuade Shell to incorporate its preferred differentials and parities in the recommended retail price and the maximum price in

the price file, and that's why there is so much interaction in relation to the price file. But on the full understanding that all that that price file is is a recommendation of a pricing policy of guidance that they put on the previous page which is in no way binding on the agent.

So they know exactly what the score is. Again, we submit wholly inconsistent with the OFT's analysis.

DR SCOTT: Going back to the requirement applied to promotions that we discussed earlier on, this is confidential, but if you go to the bottom of 210, whereas before what is mentioned in the last complete sentence on 210 had not been seen as a possibility, now it does appear to be seen as a possibility, notwithstanding the change of arrangements without knowing what it is.

MS ROSE: Are you referring to a possible promotion?

DR SCOTT: Yes.

MS ROSE: As you know, the position under the RBA is that agents can decide --

DR SCOTT: If they want to do it.

MS ROSE: -- if they want to participate in a promotion and if they do, they participate in accordance with its terms. Again, we say nothing wrong with that. And more fundamentally not a finding considered by the OFT. The

OFT's case is wholly inconsistent with this document.

Now, what the OFT chose to emphasise in this document is the sentence that you see just opposite the first holepunch on 210 under the heading "Strengths". There are a number of problems with the OFT's case on that. The first is that it's by no means clear that that sentence refers to price at all, because, as we have seen, the main preoccupation of ITL is not price, it's distribution and display. We also know that under the RBA, the agents are under an obligation to comply with instructions in relation to planograms and distribution. So there is nothing to suggest that that refers to price at all. If it does refer to price, it's factually incorrect, and I shall show you the evidence from Shell's expert witness that shows that in fact, throughout this period, as you would expect, given the contractual arrangements, the agents are not pricing at RRP and are not pricing at the maximum, they are pricing at a whole range of different prices, and there is not even very much bunching. So if that is what they were intending to suggest, it is factually wrong but you can't tell from this document if that is in fact what it means.

Over the page at 211 "Objectives", item 6:

"Bring Shell recommended prices in line with ITL required differentials."

Again we say accurately reflecting ITL's understanding of the limits of what Shell could do. Shell had no power to set prices, it could only recommend.

Then under the heading "Strategy" there is a proposal, item 5, for a Shell price file that automatic changes the Shell recommended and maximum prices once each manufacturer RRP had been altered. Two points to make about that. First, that strategy was never implemented, and secondly, even if it had been, it would only refer to the recommended and maximum prices and would still not amount to the setting of a retail price.

So the Tribunal can see the general theme of this, that we say it does not avail the OFT anything at all to show that ITL was seeking to persuade Shell to maintain differentials and parities in the price file. We say that Shell didn't consider itself under an obligation automatically to accept the proposals of ITL or Gallaher in relation to the price file, but whether it did or didn't is simply irrelevant, because the price file is nothing more than a recommendation.

Then the final one of these, again the following year, this is February 2003, this is at tab 57, and

again you see similar text on the first page about the background and the commercial structure. Then at page 220, just opposite the first holepunch, there is a paragraph relating to Annie Parker. There is much discussion then about planning and so forth. Then at 222:

"Shell recommends a pricing policy to all Select sites. The price file consists of a Shell recommended price and a maximum price for each product. A copy of the price file is provided to ITL. Under the previous category manager [that's Annie Parker] the price file was in a state of disrepair with many differentials out of line."

So it's a clear statement from ITL that Shell was not complying even in relation to the price file. That, by the way, strongly suggests that the statement "good compliance at sites" in the previous document does not relate to price, because that was in the time of Annie Parker.

"Under the new category manager and the aid of both Gallaher and ITL, this has been resolved. In the main, differentials between manufacturers' comparable brands are now maintained."

Again just talking about the price file, which is recognised as a recommendation. So those are the

internal ITL documents.

On the question of actual compliance, there is the evidence of Mr Latremoliere, this is core bundle 11, tab 123, {C11/23} and he has done a statistical analysis of the actual shelf retail prices at Shell sites over the period of the alleged infringement and compared it with the parities and differentials set out in relation to the recommended retail prices and the maximum retail prices in the price file.

Just to see the summary of his conclusions, paragraph 7.4, the figures are confidential, but you can see at 7.4 the figures that he gives for adherence to the Shell recommended retail price, and the graph, the table 2 above it, shows you the spread. There is pricing below recommended price, at recommended price, between it and the MRP, at the MRP and indeed above the maximum retail price, which is actually a breach of the RBA, but it shows that there simply isn't any compliance, certainly wholly inconsistent with this document, to suggest that the price file evidences any intention on the part of Shell to impose or set retail prices at particular levels.

We see similar statistics at table 3, and at 7.6:

"Comparing table 2 and 3 confirms adherence to the retail price was higher in 2000 and January and

February 2001 than during the period of the alleged infringement."

Which is not surprising because the period of the alleged infringement starts in March 2001, by which date the majority of the stores have already moved over to RBA.

DR SCOTT: Am I right in saying that this says nothing about the parities in differentials, this is merely --

MS ROSE: It is the retail prices and maxima, you are right, sir, but of course if you put the OFT's case at its highest, the highest the OFT's case can be put, and we say this is factually wrong, would be that in setting the recommended retail price, the maximum retail prices, Shell was adhering to the differentials and parities that ITL and Gallaher were seeking to persuade it to take on. So if you put the OFT's case as its highest, this demonstrates no compliance or no significant compliance, just a range entirely what you would expect, given Shell's commercial structure.

There is further analysis, we don't need to go to it in detail but I would invite you to read the statement, and his conclusion is at 8.2 that the results are not consistent with Shell's RBA contractors as a group treating either the recommended price or the maximum price as fixed prices in the period 1 March 2001 to

15 August 2003.

So that, we say, is the really important evidence about the relationship between Shell and ITL. What does the OFT rely on? If we go back to the decision, paragraph 6.1180 to 1240, these paragraphs set out the reasoning of the OFT. So we start on page 376. Again this is entirely formulaic. You will see exactly the same headings and much of the same text in relation to all the retailers.

The first is the heading "ITL strategy in relation to Shell's retail prices". It's difficult to see why that's relevant to whether Shell was engaged in an infringement at all, because as we have seen the question in GlaxoSmithKline is not whether ITL was intending to infringe competition law, the question is whether Shell had any intention to do a particular conduct on the market.

They refer there to ITL documents that they say demonstrate that ITL's objective was that Shell should set the retail price for ITL's brands or competitor brands in accordance with ITL's retail pricing strategy and that such strategy was communicated to Shell.

Remarkably, the documents they refer to in the following two paragraphs are the documents we have just been looking at, the national accounts business

development plan. In my submission, it is impossible to read those documents as indicating that ITL had a strategy that Shell should set the retail price for ITL's brands. On the contrary, those documents recognise that Shell had no power to set the retail price for ITL's brands and only had the power to recommend or give guidance. So again we say this is simply an impossible reading of the relevant documents.

The next heading at 378 is "Trading agreements between ITL and Shell", and here that's the analysis of the trading agreement which you have already heard my submissions on.

I've already made the point that these trading agreements are both construed completely ignoring the existence of the RBA.

Then they come on to consider the question of contact between ITL and Shell regarding retail prices, that's heading 3 at page 381, and there is a general assertion -- again this is boilerplate -- that:

"The documents evidencing the contacts between ITL and Shell demonstrate that, 1 in relation to Shell's retail prices for ITL's brands, ITL communicated to Shell what Shell's retail prices should be, or asked or incentivised Shell to hold or alter Shell's retail prices and Shell informed ITL about or discussed with

ITL Shell's current or proposed retail prices."

You will see identical paragraphs in relation to the other retailers. They are wholly inapposite to deal with the relationship between ITL and Shell, because the communications between ITL and Shell show no such thing. They do not show ITL communicating to Shell what Shell's retail prices should be, they show ITL communicating to Shell what its recommended or maximum retail prices should be, incentivising Shell to hold or alter Shell's recommended or maximum retail prices and Shell discussing with ITL Shell's current or proposed recommended or maximum retail prices. There is a complete failure by the OFT to grapple with this fundamental point.

They deal then with bonuses, you have my submission on the relevance of the size of the bonus, and then with monitoring at paragraph 6.1232. This deals with monitoring of the price file and therefore is irrelevant for the reasons that I have already given. That's the totality of the OFT's case in relation to Shell and ITL and we say it simply fails.

Can I now come on to Gallaher, and there is a significant overlap so hopefully we will be able to take it much quicker.

The trading agreement between Shell and Gallaher was

not entered into until November 2001, after the RBA was already fully implemented, so this agreement must be read in a factual matrix in which Shell has no power to dictate a retail price, only has the power to require a maximum retail price, and we submit that it simply cannot be the case, cannot rationally be asserted, given the significance of the RBA which we have already discussed, that Shell in November 2001 was intending to enter into agreement with Gallaher whereby it would set retail prices in accordance with Gallaher's differentials and parities. That is simply an impossible submission to make about Shell's intention.

Now, the agreement in question is the notice of appeal, bundle 2, tab 17. Tab 17 is not going to be a sufficient reference, given the multiplication of tabs. I will give you the page number, it's 569. It's a tab 17, one of a number.

So this is the Shell/Gallaher trading agreement:

"In consideration of Gallaher agreeing to pay the sums of money referred to below, account agrees to and shall comply with the following."

The first point to note is this is a pretty primitive agreement, we have this word here "Account" which is not defined anywhere, but we take it to refer to Shell. The evidence of Ms Parker, we don't need to turn it up but it is core bundle 11, tab 118, paragraph 10.1 {C11/118/10.1} is that she was sent this by Gallaher and she assumed it was a standard form. She would appear to have been right about that, because we also have agreements entered into by Gallaher at much the same time, with TM Retail and First Quench, which are in pretty similar form. The First Quench one is in annex 6, document 21, and the TM Retail one is annex 12, document 9.

So "Pricing":

"Account agrees to maintain the price differentials/price parities between Gallaher's brands and their respective competitive brands as set out in appendix 1 at all times. Gallaher reserves the right to amend appendix 1 from time to time after consultation with account."

If you look at appendix 1, it identifies some parities, and then "Differentials", it says:

"Benson & Hedges Kingsize, Silk Cut Kingsize and Camel houses versus Embassy No 1."

So it's very, very far from being an adequate explanation of what on earth is meant here by maintaining parities and differentials.

There is a reason why this agreement may not have

been seen as very significant by either party, and it's the obvious reason, that Gallaher knew perfectly well that Shell could not impose any price differentials or parities, and was simply talking about recommended or maximum prices in the price file.

Now, we see that in Gallaher's own response to the OFT in 2005. This is notice of appeal, volume 1, tab 3. This is Gallaher's response to questions put to it by the OFT in the course of the investigation in 2005. You see that at page 71.

If you go to page 90:

"Please confirm status of these documents. Please provide an account of any meetings subsequently conducted as referred to in the meeting follow-up email."

Gallaher say this:

"Document 210035 is a revised appendix 1 and 2 to the trading agreement sent out for signature and return."

So it's a revised version of the page we just looked at.

"Appendix 1 shows parities and differentials to reflect current RRPs. Gallaher believes these appendices were never signed or chased up. It's also worth noting that Shell does not own the vast majority

of its forecourts. Agreement with Shell would not have bound independent forecourt operators."

In fact, Shell is quite correct, because Shell did own the land, but the point is right that Gallaher knew perfectly well that Shell couldn't bind the independent forecourt operators, and that's why this agreement was not seen as terribly important.

We submit that the clause 1(a) reference to price can only be a reference to the price files, to the recommended and maximum retail prices; it can't be a reference to retail pricing, which both parties knew was simply not on the table.

So far as the size of the bonus is concerned, that's dealt with at clause 4. Before we come to that, you can see back at page 570 in volume 2 of the appeal bundle, you can see that there are clauses that deal with merchandising units and distribution of brands and packings. We submit it's clear that these are the clauses that are of real importance to Gallaher. These are the clauses that deal with planograms and distribution, and you will note that they refer specifically to compliance by stores.

If you look, for example, at 2(c) -- these are confidential, so I can't read them out -- you will see a reference to "in all stores", and if you look at 3(b),

again you will see references to a percentage of stores which will expectedly be compliant by a particular date.

So these, unlike the general pricing term, are much more specific obligations which are intended to be implemented in stores, and these again are the provisions which attract the much more substantial bonuses.

The bonus in return for compliance of provision in paragraph 1, we see the bonus that's paid, coincidentally it should appears that in the two years that we are concerned with, the actual amount of bonus paid to Shell by Gallaher is almost identical to the amount paid by ITL, even though it's a different formula it's almost exactly the same figure.

So again, the points that I made about the extent to which this is even a significant constraint on the recommended prices apply.

Then the OFT relies on general condition 5(a):

"If any store within the account store group does not comply with the term or terms of this trading agreement Gallaher reserves the right to reduce the payment by an amount it considers is appropriate."

They argue that that's evidence this is intended to impose retail prices on individual stores.

We say first of all that cannot be the right interpretation for the reasons I have already given, that both parties entering into this agreement know that Shell can't control the retail prices of individual stores; secondly that the natural interpretation of this clause in context is that it's actually referring to the specific obligations in relation to compliance by stores that apply to merchandising and distribution, where there are indeed obligations relating to particular stores.

The final point to make is that these terms are simply standard terms and you will see them repeated almost verbatim in the First Quench contract in particular.

If we now come to the OFT decision in relation to Gallaher, it starts at 6.1243 in the decision, it is the general finding, and you will note that the first date relied on is 21 August 2001, which is the first document relied on by the OFT, as we find out from footnote 1030:

"An infringing agreement existed between Gallaher and Shell whereby Gallaher co-ordinated with Shell and again the setting of Shell's retail prices for tobacco products."

So it's exactly the same format as in relation to ITL, and we see the same categories and virtually identical language used.

So Gallaher's strategy in relation to Shell's retail prices, again we say this is simply irrelevant, particularly given Gallaher's statement of what it understood.

There is one point to make about that, which is of course that Gallaher has entered into a settlement agreement with the OFT. One of the terms of that settlement agreement was that Gallaher agreed to give its full co-operation to the OFT in relation to the OFT's conduct of this appeal. So if the OFT thought that Gallaher had any evidence to give that qualified or departed in any way from the answer that Gallaher gave to the OFT's question in 2005, it was in a position to call a witness to say that, but it chose not to do so, and we submit that in that situation it's not open to the OFT to go behind that material.

Then the trading agreement between Gallaher and Shell, so this starting at 1249 purports to be the OFT's analysis of the trading agreement.

Striking, again, no reference at all to the RBA, this is simply dealt with in a vacuum.

The conclusion at 6.1256, and this is in identical **terms to the same conclusion in relation to ITL:**

"The evidence demonstrates that there was a formal agreement pursuant to which Shell would set its retail

prices in accordance with the parity and differential requirements set by Gallaher and that Shell was rewarded with the payment of a bonus for compliance with Gallaher's parity and differential price."

That's just an impossible construction of that agreement, given that it was introduced at a time when both parties knew that Shell had no power to do that.

Then contacts between Gallaher and Shell regarding retail prices. Again my submissions in relation to this are the same as in relation to ITL, what these show is Gallaher seeking to persuade Shell to change its price files, on a couple of occasions Gallaher complaining about pricing in stores. What they do not show at any point is Shell suggesting to Gallaher that it had any power to dictate to stores what they should charge or attempting to do so at any point.

So we have seen that the OFT ignores the RBA in section 6, which is the place where it should have considered it when it was considered whether, properly construed in its factual context, Shell's agreements with ITL or Gallaher were infringing agreements. It didn't do that. Instead it purported to address the RBA in section 7, and we see that at page 525, remarkably, under the heading "Legal Assessment". What's said at paragraph 7.1 is:

"This section sets out the OFT's conclusions concerning the legal assessment of the infringing agreements described above by reference to the applicable constituent elements of the chapter 1 prohibition."

Of course, the RBA has nothing to do with that, the RBA is part of the factual context within which the existence of an infringing agreement ought to have been analysed.

The RBA's addressed, we see the heading "Shell" at page 529, and starting at 7.18 there is an explanation of the changeover to the RBA, and Shell's submission is recorded at 7.22 that it was only able to suggest RRPs, had no power to dictate them.

We see the answer that the OFT has to this over the page. So Shell maintains at 7.24:

"Shell maintain that contractors decided their own retail prices subject to the maximum price in the RBA, and stated that it did not require, incentivise or pressurise contractors to price in line with parity and differential requirements, nor did it monitor contractors' prices of core range products, although it may occasionally have verified whether products were being sold above the maximum retail price."

I would add in practice that there is no evidence at all to contradict that, nothing whatsoever, not a single piece of paper to contradict that.

Then:

"Shell also submitted the fact it did not sell tobacco products or have control over contractors' pricing meant no anticompetitive agreement between Shell and the manufacturers was possible."

Then they say this:

"It is clear from the evidence at section 6(c)7 [which is the section we have just been looking at] that Shell entered into an infringing agreement with each of ITL and Gallaher."

This is pretty remarkable, because what the OFT is saying here is "We reject Shell's submission that the existence of the RBA means there was no infringing agreement, and the reason we reject that is because we have already found that they did enter into an infringing agreement, but of course they made that finding ignoring the context of the RBA as part of the background of the relationship and particularly the background of the agreements they were considering.

So they take as read the very point that they were required to prove taking into account the RBA. Then they say:

"It is equally clear that Shell was at all relevant

times in a position to implement those infringing agreements insofar as [please underline those words, insofar as] Shell had the power to specify or negotiate the terms under which the contractors were to operate the Shell owned site, including terms as to the contractor's retail pricing policies."

Now, that sentence is very difficult to understand, and it is a sentence which continues to be pivotal in the OFT's case. You will see it reappear in their skeleton argument, which I'll show you in minute. With great respect to the OFT, it is wholly meaningless. What does "insofar as" mean? It must mean that Shell may or may not have been in a position to renegotiate its contracts with individual contractors so as to permit Shell to set retail prices. They are certainly not making a finding that Shell did have the power to do that. They are saying insofar as it did, it could have done. Well, of course it's entirely circular to say "If I had the power to do X, I could have done X", but that doesn't tell you anything useful at all.

More profoundly, this statement is commercially bizarre. Shell had just completely rearranged the whole structure of its filling station business in its commercial interests, because it concluded that they were not profitable because they didn't have sufficient

autonomy and they needed to have the flexibility to respond to local conditions. Why on earth would Shell, in that situation, in order to obtain bonuses of the size we have seen, from ITL and Gallaher, have been willing to renegotiate the terms which it had just developed over a period of months and rolled out in a major programme over a period of further months? It's quite extraordinary. And this paragraph, we submit, is absolutely fatal to the OFT's case, it is wholly inadequate.

Then they say this:

"Indeed, the fact that Shell was able to impose maximum retail prices for tobacco products on the contractors illustrates the scope of Shell to influence the contractors' pricing policies."

With all due respect that is a complete non sequitur. The maximum retail price is included in the agreement because Shell has reputational concerns that the individual contractors should not price their goods so high as to damage Shell's brand, and that's made very clear in the RBA itself. You will recall that clause 576 says this is intended to be set so high that it will not interfere with your commercial freedom.

To infer from that that Shell could or would have wanted to reimpose the control over retail pricing which

it had just gone to considerable pains to divest itself of is just extraordinary.

Then at 7.27:

"Further, each manufacturer monitored Shell's compliance with the infringing agreements both centrally at Shell head office and individually at contractor sites."

What does that mean? That means two things. First of all, that ITL and Gallaher would communicate with Shell about the price files; and secondly that they would go to sites to try and persuade people to price in accordance with differentials and parities. Again it has nothing whatever to do with any agreement.

"In both cases, the evidence would seem to confirm that the infringing agreements related to the retail price of the manufactured products of Shell-owned sites irrespective of whether they are operated by Shell or contractors."

Bare assertion, with no evidence to back it up.

Then they say this:

"As the OFT has found that the infringing agreements between Shell and each of ITL and Gallaher amount to restrictions of competition by object, it's proceeded on the basis that it is not necessary to demonstrate that in relation to the infringing agreements Shell actually agreed terms as to pricing parities and differentials with the contractors operating Shell-owned site and enforced those terms, it's sufficient for the OFT to demonstrate that the terms of the infringing agreements between Shell and the manufacturers infringed the Act and that Shell and the manufacturers were in a position to implement the infringing agreements."

Again, we submit that that analysis is completely inadequate, because what it overlooks is that if the only agreement that Shell had reached with the manufacturers was to recommend particular prices or to set a maximum, then that's not an infringing agreement at all.

Then at 7.28:

"It is perhaps also worth noting that up to October 2000 all Shell-owned sites were operated by Shell [true but irrelevant] and that the transfer of the operation of those sites was not completed until approximately July 2001."

To which we say so what? Surely the OFT is not suggesting that it would have made a finding of an object infringement against Shell on the basis that a minority of its sites remained under Shell control between March and June 2001 because we have seen that by June there were hardly any left under Shell's control.

that cannot seriously be a proposition that the OFT are advanced, indeed they have never advanced it.

"Furthermore in the period following the transfer operation of Shell-owned sites, there is some evidence to suggest that Shell had agreed with Gallaher and ITL that it would ensure contractors' compliance with parity and differential requirements and/or that there was some expectation from the manufacturers Shell would do so and Shell received payments from the manufacturers for doing so."

We submit that is simply contrary to the evidence that we have looked at.

That is it, that is the totality of the OFT's reasoning in relation to Shell's business and the impact of the RBA. We submit it is obviously and fundamentally flawed.

Now, I want to look at the way it's dealt with also in the skeleton argument.

THE CHAIRMAN: Can I just pause a moment there to find out how much longer you --

MS ROSE: I am very nearly finished.

If we can just go to the OFT's skeleton argument, it's core bundle 4, tab 1, page 124, {C1/1/124} it starts at paragraph 440:

"The OFT denies that clause 5.6 of the RBA sets out

the limits of Shell's power in relation to the fixing or determination of retail prices. The evidence set out in the decision and below shows that (a) Shell entered into an infringing agreement with each of the manufacturers, (b) each infringing agreement related to retail price of the relevant manufacturers' products on Shell-owned sites and (c) each manufacturer monitored Shell's compliance with the infringing agreement."

Again, a bootstraps argument because, having decided without regard to the existence of the RBA that there is an infringing agreement, they then rely on the existence of the infringing agreement to conclude that the terms of the RBA do not accurately reflect the scope of Shell's powers to set prices. Simply the reasoning is entirely the wrong way round. What is the basis for the bare denial at the beginning of 440 that clause 5.6 does not set out the limits of Shell's power in relation to fixing or determination of retail prices? The three subparagraphs (a), (b) and (c) are irrelevant to that question.

There is no suggestion by the OFT anywhere that the RBA is a sham. That would be a remarkable suggestion, given its commercial significance for Shell, and there is no evidence identified by the OFT suggesting that notwithstanding one of submissions in clear and

unequivocal terms of the RBA, including its entire agreement clause, that there is some other power that Shell would be able to exercise to set retail prices.

441:

"The evidence also demonstrates that at all relevant times, Shell was in a position to implement the infringing agreement insofar as [and here it is again, here is the same formula] Shell had the power to specify or negotiate the terms under which contractors were to operate the Shell-owned sites."

It's exactly the same formula repeated. It made no sense when it appeared in section 7 of the OFT's decision, and with great respect to my learned friends it makes no more sense now.

Trying to understand it, what they seem to be suggesting is even if Shell didn't have the power to set retail prices under the RBA, it could have renegotiated the RBA to give itself that power, and that in some way makes this an infringing agreement. So the proposition seems to be, if you are in a situation where you are not in a position to engage in conduct that has an adverse effect on competition, the fact that you might be able to negotiate an agreement in the future that would permit you to do it is enough for an object infringement. I am afraid I just don't understand that reasoning process.

442:

"Shell argues that it could not have entered into trading agreements with the manufacturers with the intention or purpose to set retail prices in accordance with the manufacturers' parity and fixed differential requirements as this would have been contrary to the terms of the RBA. Nevertheless the evidence showed Shell did in fact enter into such agreements".

Again the cart before the horse argument begging the question.

"The evidence does not show Shell intended to comply with the RBA rather than the trading agreements. On the contrary, the evidence shows that Shell acted on the terms of the trading agreements."

I stress there is simply no evidence at all that Shell ever sought to impose retail prices or relativities or parities on any of its contractors.

Then there is the point made that the manufacturers were aware of the terms of the RBA and all they say is that despite any knowledge the manufacturers may have had, they still expected Shell to set the retail prices in accordance with their parity and differential price.

Contrary to the evidence you have seen the internal documents for ITL which demonstrate that that's simply

wrong and you have also seen the Gallaher response to the OFT which again shows that that is wrong.

That, again, is the entirety of the OFT's reasoning in relation to RBA and we submit it does not hold up.

Now, I wanted to say something about ground 1 but I am now very short of time. Can I simply make the following points very briefly: first, that we maintain all of the arguments set out in our skeleton argument; secondly, that the essence of our submission in relation to ground 1 is that the action taken against Shell by the OFT amounts to an abuse of process because it was unfair and discriminatory and contrary to the OFT's own policy.

The OFT itself, in its decision -- it's paragraphs 2.100 to 101 -- set out a clear policy that it would only proceed against companies that had at least a 1 per cent market share. We make two complaints, firstly that the setting of that policy in itself had a discriminatory and disproportionate impact on Shell because, on the OFT's logic, only Shell and Esso had slightly above the 1 per cent, the OFT decided that Shell had a 1.11 per cent market share, and the OFT then decided not to proceed against Esso, so Shell found itself the only petrol retailer to be accused and then found guilty of participation in unlawful conduct with

reputational potentially financial implications for it, and we submit that that in itself is a factor that the OFT ought to have taken into account when it set its policy, its discriminatory impact.

Secondly, we submit that in any event it breached its own policy because Shell could not be shown to have more than a 1 per cent market share and that's the expert evidence of Mr Heard. I will take up the detail of those points in my closing submissions because I don't have time to deal with that now.

Unless there is any other matter on which I can assist the Tribunal, those are the opening submissions on behalf of Shell.

THE CHAIRMAN: Thank you very much. Speedy though it was, it was also very helpful. So thank you for that. We will take on board the points that you make in relation to ground 1, and certainly you won't be disadvantaged by the fact that you were only able to refer in brief to those.

So tomorrow we will have a chance to reflect on what's happened so far, and Mr Brealey, do you have anything that you can usefully give us to do over the ...

MR BREALEY: What I can do, madam, is give the Tribunal, and then I'll give the other parties a copy, of basically

the opening submissions, in a speaking note, so at least the Tribunal will know the cases I was going to refer to, where I was going and why I was saying it. It's not a kind of ready made document, it is something that was a speaking note, but I think it will shorten things, that's the good news, the bad news is it will give you three days to ask me some tricky questions, but I think it will shorten it on Monday morning.

THE CHAIRMAN: You can distribute that in due course in the usual way. Thank you very much everywhere. I think we are meeting, some of us, at 10 o'clock Monday morning. Is that right? Then on the Tuesday I think we are meeting at 10.30. Thank you.

(4.53 pm)

(The court adjourned until 10.00 am on Monday, 26 September 2011)

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