Response to the CMA's draft revised Guidance as to the appropriate amount of a penalty

Introduction

The CMA's draft Guidance as to the appropriate amount of a penalty, 'the draft Guidance', (published 2 July 2021) states that the starting point for determining the level of financial penalty which will be imposed on an undertaking is calculated having regard to: the seriousness of the infringement and the need for general deterrence; and the relevant turnover of the undertaking.[1]

A casual reader may believe that the relevant turnover affected by the infringement is the turnover the undertaking earned on the products (or services) over which the infringing activity took place. However, this is not necessarily the case.

The draft Guidance also states that the "*The relevant turnover is the turnover of the undertaking in the relevant product market and relevant geographic market affected by the infringement in the undertaking's last business year*";[2] and refers to the published guidance on Market Definition for further information.[3]

This note briefly explains how the relevant turnover is determined and suggests that the CMA should elaborate on this in its guidance given the primary role this may play in setting fines. A greater explanation of the role of market definition would better inform businesses, and their advisers, on the size of potential fines and reduce the room for controversy over fines.

The hypothetical monopolist test

The CMA's Market Definition guidance explains that the hypothetical monopolist test is applied to assess the relevant product and geographic market. The hypothetical monopolist test starts with the focal products – in the context of an antitrust infringement, these are those products over which the anticompetitive conduct took place. The CMA will then consider whether there are any demand and supply side substitutes which would broaden the relevant market and may, therefore, increase the relevant turnover of the infringing parties. Demand and supply side substitutes are those which are sufficiently close substitutes that they would constrain a hypothetical monopolist of the focal products from increasing prices by 5 to 10 per cent.

Demand side substitution

The logic for expanding the relevant market, for the purpose of setting fines, on the basis of demand side substitution is fairly clear. If the anticompetitive activities of a company lead to an increase in the prices of a product, then some demand is likely to be displaced to demand side substitutes as some customers seek to avoid the price increase. This increases the sales of those supplying demand side substitutes and may also push up the prices of these products, making them more profitable for suppliers. If the company engaged in the anticompetitive activities also supplies some demand side substitutes, then it will likely also have benefited through these due to the anticompetitive activities, particularly if there is an increase in the price of the products due to the increase in demand. By including demand side substitutes supplied by the company in the relevant turnover and, therefore, in the turnover used in setting the fine, the authority seeks to ensure that the company does not

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[1] CMA's guidance as to the appropriate amount of a penalty, CMA 73, published 2 July 2021, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/786661/CMA_s_guidance_as_to_the_appropriate_amount_of_a_penalty___clean_copy.pdf

[2] Paragraph 2.11.

[3] OFT403 https://www.gov.uk/government/publications/market-definition

benefit from, and is punished for, its anticompetitive activities through the supply of demand side substitutes.

The logic for including supply side substitutes in the relevant turnover is less clear.

Supply side substitution

The CMA's Market Definition document explains supply side substitution in the context of applying the hypothetical monopolist test: "*If prices rise, undertakings that do not currently supply a product might be able to supply it at short notice and without incurring substantial sunk costs. This may prevent a hypothetical monopolist profitably sustaining prices 5 to 10 per cent above competitive levels. This form of substitution is carried out by suppliers and hence is known as supply side substitution*".[4]

If a company engages in anticompetitive activities over a set of products, this may push up the price of those products. As explained above, it may also push up the price of demand side substitutes. However, it will not increase the demand for, or push up the price of, supply side substitutes.[5] Therefore, if the infringing company sells supply side substitutes, it will not benefit through these products due to the anticompetitive activities. Therefore, the logic for including these supply side substitutes in the relevant turnover, which increases the fine, is less clear. It could be that supply side substitution could undermine the deleterious effects of the anticompetitive activities. Therefore, if an infringing company controls some of these supply side substitutes, then it is less likely to enter rapidly to supply these products in response to the cartelisation of the market. This may justify greater punishment through a higher fine.

Whether or not there is a clear logic for applying it in the context of setting fines, it is well established that supply side substitution is a standard element of market definition.

Competition authorities will often take a cautious approach to including products in the relevant market on the basis of supply side substitution in CA98 cases. The application of supply side substitution may also differ depending on the competition tool which the authority is using.[6]

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[4] Paragraph 3.13.

[5] This is, perhaps, an oversimplification. Supply side substitution responds to the higher price of the focal product. Therefore, if the infringing firm were to enter into the supply of the focal product, it would receive a higher price/margin when supplying these focal products. In addition, the diversion of supply to the focal products may lead to an increase in the price of products in the market originally supplied by the supply side substitutes (and which may still be supplied), if the supply of these products is inelastic. However, such effects appear only to be notional. The infringing firm is highly unlikely to use its assets to engage in supply side substitution in response to a higher price (driven by anticompetitive activities) and, so, any impact on the demand and price, for supply side substitutes which it produces, is unlikely to arise.

[6] It is notable that the description of supply side substitution is quite different between the CMA's *Market Definition* document and the CMA's *Merger Assessment Guidelines*, with the latter appearing to set materially more demanding requirements for products to be considered as supply side substitutes. The merger guidelines state that the boundaries of the relevant market are generally determined by reference to demand side substitution alone. In addition, the merger guidelines require two cumulative conditions to be met for the relevant market to be broadened on the basis of supply side substitution: (a) that firms routinely use their existing production assets to supply a range of different products that are not demand-side substitutes and there is evidence that firms in practice shift their existing capacity between these different products depending on demand for each; and (b) the same firms compete to supply these different products and the conditions of competition between the firms are the same for each product. These additional requirements do not appear generally to be applied in the context of setting fines for antitrust infringements.

However, in some industries, the size of the relevant turnover may by expanded greatly on the basis of supply side substitution.

For example, consider a large technology company whose costs of supply are largely fixed and which has established itself in serving a particular service with a large and valuable customer base. Imagine that it then expands into serving a small (and not very valuable) niche market and incurs only relatively small marketing costs in doing so, relying on the technology it has developed to serve the main market. The company also engages in infringing anticompetitive activities in the niche market but only derives relatively small turnover from this niche market. Although the company did not engage in infringing conduct in relation to its main market, the turnover from this market could be included in the relevant turnover (along with the turnover from the niche market) on the basis of supply side substitution. It appears that the company could enter this niche market quickly and without incurring substantial sunk costs. This would lead to the relevant turnover being much higher than the turnover from the focal products.

For the sake of completeness, I note that the authority may also aggregate across relevant markets, even though these are not necessarily demand or supply substitutes. This is done for ease of expression and does not affect the size of the relevant turnover and, therefore, the fine relative to a disaggregated approach. For example, in the bathroom fittings RPM case, the CMA defined a relevant market for bathroom fittings even though the different bathroom fittings (e.g. shower trays, bathroom furniture, etc) were not assessed as being demand or supply side substitutes.[7] However, an SO is easier to read when it talks about bathroom fittings rather than listing at every instance each type of bathroom fitting which was subject to the infringing behaviour.

The importance of the relevant turnover to setting fines

The starting point for setting the fine in a CA98 infringement is the relevant turnover, determined by the relevant product market. If the relevant product market is determined to be broader than the focal products, whether on the basis of demand or supply side substitution, or both, then the authority will consider whether the infringing parties also earn turnover in those products included in the expanded relevant market. If so, then this turnover becomes part of the relevant turnover.

If the infringing parties do not earn revenue from products which are demand or supply side substitutes, then it makes no difference to the relevant turnover, and fine, whether these products are included in the relevant market or not. Therefore, the authority may choose not to define a relevant product market broader than the market for the focal products, even though demand and supply side substitutes exist.

It is often the case, in CA98 infringement decisions, that the relevant turnover is no greater than the turnover from the focal products. However, it would be a mistake for companies, and their advisers, to presume that the authority would take this approach. To do so risks underestimating how a broader relevant market may increase substantially the size of the fine.

The CMA's draft revised Guidance explains how various adjustments may be made to this starting point provide by the relevant turnover (for example, based on the serious of the offence, cooperation with the authority, etc). However, if one starts with a relatively small number, it will tend to stay relatively small after the various adjustments, whereas if one starts with a relatively

[7] Paragraph B. 12. Online resale price maintenance in the bathroom fittings sector, 10 May 2016. https://assets.publishing.service.gov.uk/media/573b150740f0b6155b00000a/bathroom-fittings-sector-non-conf-decision.pdf

large number, it will tend to stay relatively large. Therefore, market definition may play a primary role in setting the size of the fine.

When 'relevant turnover' has been considered by the courts

The role of the relevant turnover was considered by the courts in the appeals of the OFT's decision in *Replica Kits*.[8] The Court of Appeal in that case found that the OFT could apply a less rigorous approach, not requiring detailed economic analysis, to identify the relevant markets in which a 'by object' infringing agreement produced effects. In arriving at a figure for the 'relevant turnover' for fining purposes, the authority could take account of turnover not only in products directly affected by the infringement, but also of products in neighbouring markets which may reasonably be considered to have been affected by the infringement.[9]

Products in neighbouring markets 'affected' by the infringement clearly may apply to demand side substitutes. As discussed above, it is less clear that supply side substitutes are affected by the infringement.[10] It might be argued that the inclusion of supply side substitutes in the relevant turnover has not been explicitly recognised and established by the courts. Therefore, clarifying guidance from the authority would add value.

Any lack of clarity could be exacerbated by the less demanding standards which the analysis of market definition needs to meet in 'by object' Chapter I infringements relative to, say, a Chapter II case.[11] This allows greater room for controversy over the extent of the relevant market and, ultimately, the size of the fine.

Room for controversy or misunderstanding is greater still because the European Commission takes a different approach in establishing the starting point for setting fines in antitrust cases. The Commission's guidelines state that the Commission will "refer to the value of the sales of goods or services to which the infringement relates as a basis for setting the fine".[12] In other words, the Commission's starting point when setting fines is the revenue from the infringing (focal) products and it does then consider demand and supply side substitutes, which could increase the revenue included in the starting point.

Conclusion

In my experience, businesses and their advisers are sometimes unclear about the role which market definition plays, and particularly the role played by demand and supply side substitution, in setting the size of fines. They are surprised when the starting point for the fine may be substantially larger than the revenue earned by the company from the products over which the infringing activity took place. This may particularly be the case in relation to supply side substitutes where the logic for including these, and the courts' explicit recognition for this, is less clear. The inclusion of supply side

[8] Paragraph 169 of the Court of Appeal's judgment. https://www.catribunal.org.uk/sites/default/files/Jdg_CoA_1014Argos_Little_JJB191006.pdf

[9] Paragraphs 171 and 173 of the Court of Appeal's judgment.

[10] In its decision in Replica Kits, it appears that the OFT considered demand and supply side substitution but decided on the facts in that case not to expand the market.

[11] It is enough that the CMA/PSR are "*satisfied, on a reasonable and properly reasoned basis, of what is the relevant product market affected by the infringement*". Argos Limited and Littlewoods Limited v OFT and JJB Sports plc v OFT [2006] EWCA Civ 1318, paragraph 170.

[12] Paragraph 5, Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No 1/2003, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52006XC0901(01)&from=EN

substitutes in determining the extent of the relevant market generally is well-established. The CMA's Guidance could be clearer in setting out its role, and the process for defining the relevant market more generally, in the determination of the relevant turnover for the purpose of setting fines in CA98 infringements.