Illuminating Section 2 Through Cartels

Presentation by Robert C. Marshall,
The Pennsylvania State University
Bates White, LLC

September 26, 2006

FTC/DOJ Hearings—Understanding Single Firm Behavior: Empirical Perspectives Sessions

Paper in progress with same title by Randal D. Heeb, Robert C. Marshall, and Leslie M. Marx

Agenda

- Fundamental difficulties with Section 2 analysis
- Viewing monopolization through cartel conduct
- A firm’s profits depend on the “five forces”
- Section 1 and 2 viewed through the lens of “five forces”
- Examples of monopolization behavior from recent cartel cases

Fundamental difficulties with Section 2 analysis

- Separating competitive and anticompetitive behavior is difficult
  - A “good” but-for world is difficult to define
- What is illegal and what is not for a dominant firm?
  - When a cartel uses its market power this question does not arise

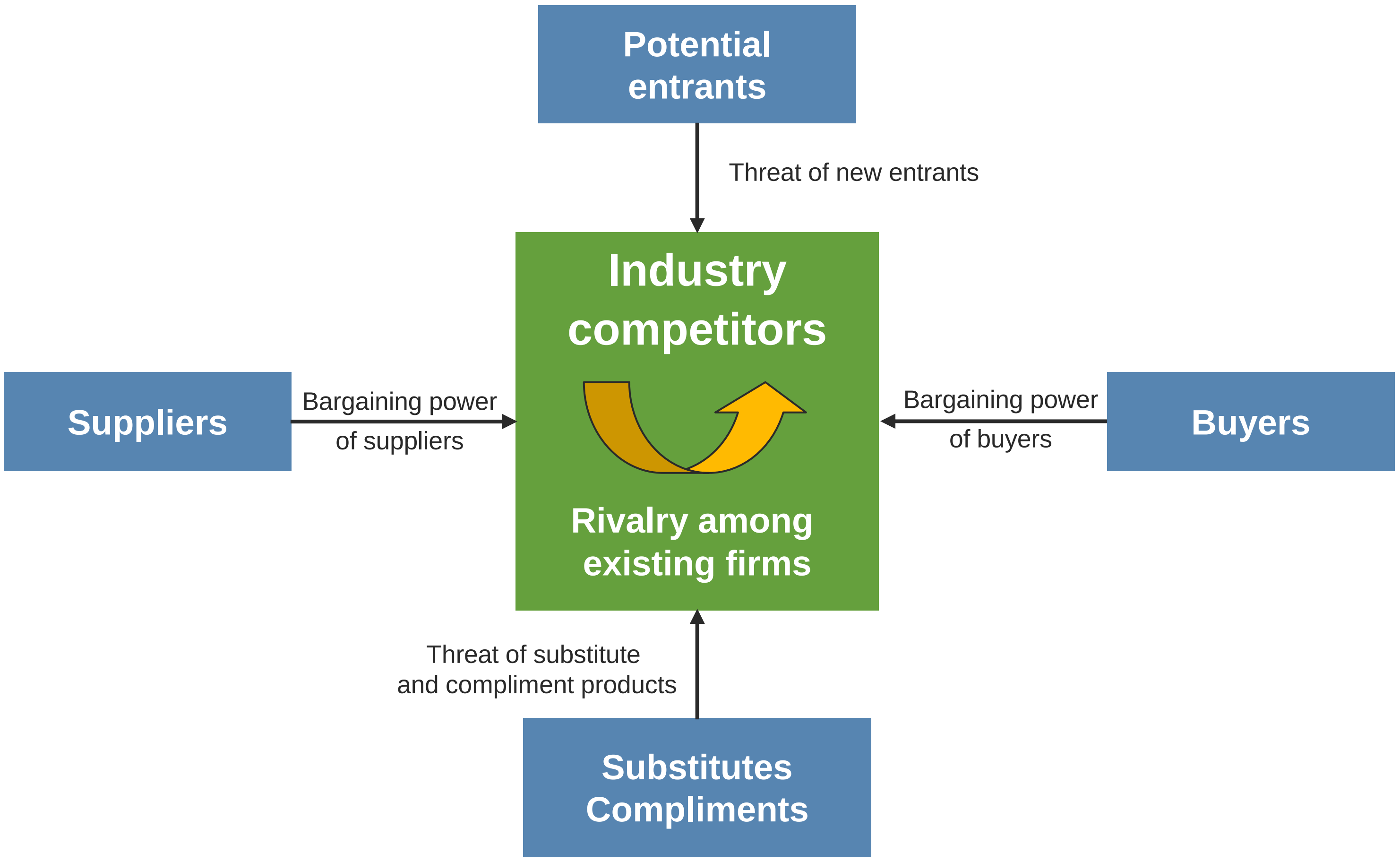
Viewing monopolization through cartel conduct

- A cartel can be like a single large firm in many ways, albeit cartels are highly heterogeneous in their cohesion and stability
- Suppression of rivalry and elevation of prices and profits are central goals
- However, some cartels engage in behavior like that of a single large firm with market power
  - Predation
  - Blocking entry
  - Exclusive dealing (customer allocations)
  - Bundling

Viewing monopolization through cartel conduct (continued)

- Why do some cartels engage in Section 2-like behaviors that other cartels do not?
- Some advantages of looking at Section 2 through cartels
  - Many cartels have been busted so there is a discovery record
  - Cartels begin and end so that distinct regime shifts can be observed
  - Contrast between cartels (e.g., products, number of firms, size of fringe, industry structure, market characteristics) in terms of monopolization conduct provides a rich cross section of data
- Why would certain alleged monopolization behaviors rarely or never be observed in cartels?

A firm’s profits depend on the “five forces”



Source: Figure by Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980), 4.

Section 1 and 2 viewed through the lens of "five forces"

- The inner force, interfirm rivalry, is Section 1
- The outer forces are Section 2 (perhaps)
- But once you have the inner force under control, why would a cartel not act on the outer forces?

Examples of monopolization behavior from recent cartel cases

- **Citric acid**
- **Carbon brushes**
- **Vitamins**
- **Sorbates**

All subsequent paragraphs reference European Commission decisions

Citric acid: Predation

- Participants ‘accepted that there would have to be a price war against the competition from China’ (67) and that they had to ‘try and regain particular accounts [lost to the Chinese producers] at whatever price was necessary with the blessing of the others’ (68).‘These customers were identified by name, and were allocated to individual participants, who were to make the necessary offers’ (69). This catalogue of undertakings came to be known as the ‘Serbia List’ and was the subject of regular monitoring and discussion at subsequent ‘Sherpa’ meetings, the first of which were held in London from March 23–25, 1994. (Paragraph 119)

Source: Case No COMP/E-1/36 604—Citric acid. 12.5.2001.

Carbon brushes: Predation

- According to Morgan, another way in which cartel members tried to ensure that the price levels which they had agreed could be maintained in practice in the marketplace was by exchanging information on and jointly acting against competitors. Agenda’s of Technical Committee meetings often had a separate point called “Competition.” Under this heading the cartel’s strategy to take action against troublesome competitors was discussed and coordinated. (Paragraph 167)
- The main strategies in this respect were to
  - Lure competitors into cooperation
  - Drive competitors out of business in a coordinated fashion or at least teach them a serious lesson not to cross the cartel
  - Buy up competitors. Once such companies had been taken over, the parent company would ensure that they complied with the rules of the cartel. (Paragraph 167)

Source: Case No C.38.359—Electrical and mechanical carbon and graphite products. 3.12.2003.

Carbon brushes: Predation (continued)

- A local meeting in Germany on May 7, 1992 records a discussion among cartel members on how best to act against EKL, a competitive East-German cutter that had entered aggressively into the West-German market after unification (Paragraph 157)

- Two strategies were agreed
  - None of the members of the cartel would supply any graphite to EKL
  - EKL would be denied any market share by systematically undercutting it with all customers, so that it would not be able to sell anywhere. EKL was taken over by SGL in 1997. (Paragraph 157)

Source: Case No C.38.359—Electrical and mechanical carbon and graphite products. 3.12.2003.

Carbon brushes: Standardization

- Ban on advertising (Paragraph 152)
  - The cartel agreed not to advertise, nor to participate in sales exhibitions

Source: Case No C.38.359—Electrical and mechanical carbon and graphite products. 3.12.2003.

Vitamins: Eliminate competitors

- In 1993, the parties realized that a U.S. producer, Coors, had a larger production capacity for vitamin B_2 than they had estimated in 1991. In order to prevent Coors from disrupting their arrangements by the export of its production surplus, Roche and BASF agreed that the former would contract to purchase 115 tonnes of vitamin B_2 (representing half of Coors's capacity) in 1993. BASF in turn would purchase 43 tonnes from Roche; the burden was thus to be shared in the same 62:38 proportion as their quotas. Later Coors sold its vitamin B_2 plant to Archer Daniels Midland (ADM). In 1995, Rhône-Poulenc and ADM contracted for Rhône-Poulenc to market in Europe the riboflavin produced by ADM in the United States of America. (Paragraph 287, 288)

Source: Case No COMP/E-1/37.512—Vitamins. 21.11.2001.

Vitamins: Predation via a bundled commodity

- According to Daiichi, BASF and Roche had another strategic incentive to raise the price of calpan and indeed of other vitamins used for animal feed. Both have a strong market position in pre-mixes by virtue of their integrated production of the vitamins used. By increasing the prices of the vitamins used in pre-mixes, they would put a price squeeze on their competitors in this downstream activity, and over time drive the smaller pre-mixers from the market. (Paragraph 322)

Source: Case No COMP/E-1/37.512—Vitamins. 21.11.2001.

Vitamins: Market power

- A key result of the anti-competitive agreements in each of the vitamin product markets was to combine the market power that the participants held in each of the individual markets. This was most effective for those companies which produced and sold the widest range of vitamin products, i.e. Roche and BASF. (Paragraph 713)
- As suppliers of a wide range of vitamin products, these companies enjoyed a number of advantages. In particular, their position in relation to their customers was stronger than companies selling a single or limited number of products, since they were able to provide a range of products and accounted for a greater proportion of their business. In addition, they enjoyed greater flexibility to structure prices, promotions and discounts and had a much greater potential for tying. They were also able to realize greater economies of scale and scope in their sales and marketing activities. Finally, any implicit (or explicit) threat of a refusal to supply would have been much more credible. (Paragraph 714)

Source: Case No COMP/E-1/37.512—Vitamins. 21.11.2001.

Sorbates: Blocking entry

- Non-supply of technology to potential market entrants
  - During the joint meetings, there was considerable discussion about new market entrants, particularly the Chinese and the Russians. In the late 1980s and during the 1990s, several potential competitors from China requested sorbates technology from the existing producers, but Hoechst and the Japanese producers decided that no technology would be provided to other sorbates producers. Hoechst, in agreement with the Japanese producers, also encouraged [...]not to transfer sorbates technology to potential competitors. Discussions among the conspirators involved reporting on enquiries from potential market entrants and reporting on companies' individual decisions not to sell such a technology. (Paragraphs 117, 118)

Source: Case No COMP/E-1/37.370—Sorbates. 01.10.2003.

BATES WHITE

CAPCP

•••BATES•WHITE•••

Illuminating Section 2 Through Cartels

Presentation by Robert C. Marshall,
The Pennsylvania State University
Bates White, LLC

September 26, 2006

FTC/DOJ Hearings—Understanding Single Firm Behavior: Empirical Perspectives Sessions

Paper in progress with same title by Randal D. Heeb, Robert C. Marshall, and Leslie M. Marx

CAPCP
The Center for the Study of Auctions, Procurements and Competition Policy at Penn State