

# ADMINISTRATIVE PENALTIES — IMPACT AND ALTERNATIVES

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## Abstract

Administrative penalties are imposed in South Africa for a specified set of prohibited practices. These are typically the most egregious anti-competitive acts, and therefore the main purpose of administrative penalties is to act as a deterrent, both to the offending firm and to other firms that may consider engaging in similar behaviour. With a spate of high-profile cases resulting in fines, there has been much discussion over fines and their ultimate impact on businesses and consumers. We discuss three arguments that have been raised. Firstly, we consider whether companies simply pass the cost of their fine through to consumers in the form of higher prices. Secondly, we look at the validity of the complaint that high fines could lead to poorer competitive outcomes due to firm exit. Thirdly, we assess suggested alternative mechanisms for disbursing the fine such as paying the fine in the form of lower prices.

## Keywords

Administrative penalties, fines, competition, firm exit, alternative fining methods, pricing, pass-through

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## 1. INTRODUCTION

Administrative penalties imposed on companies that violate competition law are common in numerous jurisdictions, including South Africa. These penalties serve a *retributive* purpose by punishing the transgressing company for illegal conduct such as cartel activities and abuse of dominance. They also serve as a *deterrent* to future violations of competition law by both the company concerned and other companies that might otherwise consider engaging in similar conduct. In *The Commission v Federal Mogul Aftermarkets* (Competition Tribunal, 2003), the Tribunal established that the primary role of the administrative penalty in South Africa is deterrence rather than retribution.

This role is crucial given the high costs to society of anti-competitive behaviour in a market, particularly behaviour that is *per se* prohibited. Economically, the incentive for a company to engage in abuse of competition law is determined by a weighing up of costs and benefits of engaging in the abuse, which in turn depends on

- a) the probability of and lag in detection,
- b) the probability of being found guilty,
- c) the size of the penalty likely to be imposed (and reputation effects), and
- d) the size of the likely benefits in this period.

The size of the penalty imposed therefore feeds directly into a company's incentive to breach competition law and hence the deterrent value of the fine. Authorities would therefore understandably seek the highest fine level legally allowable within the legislation. Recent statements by the Competition Commissioner (Bizcommunity.com, 2010) and the Competition Commission's current appeal against the Tribunal's decision in *Pioneer* (Competition Commission, 2010a) with respect to the level of the fine administered appear to be indicative of an attempt to increase the level of fines possible in order to further emphasise their role in deterrence.

However, the high fines recently levied by the authorities have led to increased debate regarding both the level and impact of fines on company behaviour. Recent comments centre on three issues.

- Firstly, observers have been concerned that high fine levels could lead to higher prices for consumers, *as firms may attempt to recoup their fine through higher prices*. The popular argument here is that that consumers, rather than the offending firm, ultimately *pay* for the fine.
- Secondly, this has led to speculation from some quarters, including Cosatu, that an *alternative method for fining*, such as forced price decreases for companies, *may be better for the public* as a whole than a once-off fine to the National Treasury (which is currently the status quo). See for example Cosatu (2010).
- Thirdly, on the other hand, business has raised concerns that excessively high *fines could lead to company closure*, which would have adverse consequences on business and consumers.

For example, in response to Competition Commission recommendations of a 10% fine for price-fixing in the bicycle industry, numerous store owners noted that given their margins, a fine of 10% of turnover would effectively put them out of business (Business Report, 2010). If company

closure were to occur as a result of a fine this would potentially reduce competition in a market further, or limit future investment.

This paper seeks to discuss and explore these contentions in greater detail.

- Firstly, we discuss some of the economic theory related to cost pass-through to determine the extent to which a once-off penalty such as an administrative fine would be passed through to customers in theory. We also consider whether it could impact on investment and entry.
- Secondly, we discuss the circumstances under which a fine could have an unintended adverse effect on competition and/or pricing through firm closure, or impact on entry and investment.
- Finally, we discuss some of the alternative mechanisms that could be used in place of a once-off fine, with a focus on a price pass-through to consumers suggested by Cosatu, to determine if these may indeed be better.

## 2. IMPACT OF A FINE ON PRICING – WILL THE FINE BE ‘PASSED THROUGH’ TO CONSUMERS?

As a starting point we examine the contention that a fine could be *passed through* to consumers in the form of higher prices. As a basis we examine the impact of a fine on the pricing behaviour of a firm and the competitive dynamics of a market. We show that in terms of economic theory, an administrative penalty would not generally have a distortionary effect on prices in the market.

Neoclassical economic theory posits that the level of output and pricing at which a firm's profits will be greatest is where its marginal (incremental) revenue equals its marginal (incremental) cost (Varian, 1992:24). Producing more than this level (at a lower price) will reduce firm profits, as any additional units will have an incremental cost higher than the incremental revenue. Similarly, producing less than this level (at a higher price) will also reduce firm profits, as the firm could still sell additional units at an incremental profit (as incremental revenue would exceed incremental cost). This will not change unless there is a change in the demand curve, which would usually be caused by changes in consumer preferences and behaviour.

Under these conditions we expect an administrative penalty to have *no impact on the level of output or pricing of a penalised firm*. This is because the administrative penalty is a sunk cost and hence the key decision variables, marginal cost and marginal revenue, are not affected. After having a fine imposed, the firm will continue to maximise profit, as this remains the best strategy for maximising returns to shareholders. For this reason, a firm's profit-maximising decision, and in particular the price-quantity combination at which profits are maximised, should be entirely independent of any fines administered against the firm. This is one of the key benefits of administrative penalties.

Developments in the experimental economics literature suggest that actual behaviour may deviate from that suggested by neoclassical theory. However, as pointed out by Motta (2007), in this scenario, even if a firm wished to raise prices post-cartel, this would be difficult without explicit or tacit collusion. Furthermore, he notes that tacit collusion would be unstable. *For example*, any supply or demand shocks would mean that tacit collusion between firms is unlikely to result in the same price levels as under explicit collusion (in the case of a cartel). The

instability of this outcome would be increased further if firms within the industry are fined asymmetrically, or if one or more firms have immunity, which would give them a greater incentive to undercut their rivals (Motta, 2007).

Using event study analysis, Langus and Motta (2007) show that, in the European Union (EU), share prices and the market value of firms fall following a dawn raid, the announcement of an investigation, or when there is an adverse finding. Similar event studies of the impact of fines and other adverse competition events based on stock market data have been conducted, including that by Bizjak and Coles (1995), which found similar results to those by Motta (2007). Other studies such as Beverley (2008) have been less conclusive. The finding of an adverse impact on share prices and market value is consistent with the notion that the income (and thus profits) of the firm is likely to fall following an investigation or fine. Importantly, Motta (2007) shows that the drop in share value following an adverse event or ruling cannot be explained by the fine alone, thus implying that the market expects the firm's profits to go down due to the ruling. This is in stark contrast to the proposition that firms could increase prices in order to recover losses (or lost profits) from the fine.

### 3. IMPACT OF A FINE ON FIRM FINANCES

While administrative penalties are designed to be sufficiently severe so as to a) deter the offending firm from repeating the offence or engaging in similar offences and b) deter other firms that may consider engaging in similar behaviour from doing so, a fine could potentially have severe consequences on the finances of a firm. This could happen in two ways.

- Firstly, the direst possible impact on the offending firm would be that the fine *would force the firm to exit the market*. The fine may be sufficiently large so as to result in bankruptcy or insolvency such that the firm ceases to operate as a going concern. This may be a particular concern if a firm is highly leveraged and the fine prevents it from meeting its debt obligations.
- Secondly, the fine may impact the firm's finances such that its *investment decisions are affected*. The firm may simply have insufficient capital to engage in investments that it otherwise would have or be forced to consider possibly sub-optimal funding mechanisms like debt financing at unfavourable terms such that investments are delayed, downscaled or simply not made.

#### 3.1 Exit of the firm

The exit of a firm from the market could, under certain circumstances, reduce the level of competitiveness in a market. In this instance, the competitive benefit provided by the deterrence factor of the fine could be outweighed by the competitive harm it causes in the market as a whole.

While the restriction of fines to 10% of turnover may to some extent mitigate the danger of bankruptcy and thus exit (Motta, 2007), the extent to which competitive harm would occur if a firm were forced to exit would depend on a number of factors. The importance of the firm as a competitor would be one such factor. If there are several other competitors in the market and the firm does not have a strong constraining influence on prices it is unlikely that the exit of the firm will result in serious competitive harm.

Additionally, the exit of the firm may not impact on the competitiveness of the market if its assets remain available for sale to new entrants or rivals. Furthermore, the manner in which its market share is reallocated also determines the extent to which competition is impacted.

In these instances, we believe that an approach that weighs up the potential harm to consumers and society, akin to that utilised in a *failing firm* defence in the case of an otherwise anti-competitive merger, may be appropriate. Essentially the failing firm defence relies on two factors.

- Firstly, the failure and complete exit of the firm must be likely (if the most likely outcome is that another firm would purchase the allegedly failing firm, this would not be considered a complete exit).
- Secondly, the effect on competition (i.e. the difference between the counterfactual of a firm failing and exiting the market and the predicted level of competition following the acquisition of the failing firm) must not *be substantial*.

Note that in the EU, there must be absolutely no impact on competition for the failing firm defence to be applied (European Commission, 2004b) – a higher bar than the South African test.

The essence of merger analysis in competition law is to determine whether the acquisition of one company by another would result in a competitive outcome that is substantially inferior. However, merger analysis makes allowance for instances in which an outcome that seems to be anti-competitive (a merger which would otherwise be prohibited) is trumped by the likelihood that the counterfactual (a failing firm) is likely to be no better. The instance of weighing the benefit of a fine against the harm that could occur if it precipitated exit would be similar and could potentially use the two criteria outlined above as a guideline.

Furthermore, the possibility of adverse effects on the market as a result of an inability to pay a fine has been identified to some extent by other competition authorities. Guidelines and legislation have been developed to minimise the likelihood of these effects. These could potentially provide general rules to determine instances in which a fine could deviate from the norm and have distortionary effects in the South African context.

In the EU Guidelines on setting fines (European Commission, 2006), provision is made for the European Commission to mitigate fines based on an *inability to pay*, in certain circumstances. The guidelines state:

*In exceptional cases, the Commission may, upon request, take account of the undertaking's inability to pay in a specific social and economic context. It will not base any reduction granted for this reason in the fine on the mere finding of an adverse or loss-making financial situation. A reduction could be granted solely on the basis of objective evidence that imposition of the fine as provided for in these Guidelines would irretrievably jeopardise the economic viability of the undertaking concerned and cause its assets to lose all their value.* (European Commission, 2006:par. 35)

While much of the case precedent in terms of ability to pay was based on the previous guidelines, which were issued in 1998 (European Commission, 1998), the text of the guidelines has largely stayed the same. Furthermore, we anticipate that the most recent guidelines would have been informed by case precedent and the European Commission and courts' interpretation of the previous guidelines. Therefore the case law remains relevant.

The Copper Plumbing Tubes case (European Commission, 2004a) constitutes a test for the

inability to pay a fine, which is based on proof of two key elements.

- *Firstly, it is necessary to prove risk of immediate bankruptcy. In Copper Plumbing Tubes* the European Commission states that “the undertaking must demonstrate that it could not meet its contractual obligations (debts, including that of the fine), and therefore risk an immediate bankruptcy” (European Commission, 2004a:par. 821). The Commission refers to this as the “only reliable test” that a firm is unable to pay a fine. This case also shows that extraordinary items that merely affect the profitability (such as restructuring costs and provisions for the fine) of the firm would not be persuasive. Therefore in order to meet this test, the fine must result in a situation that goes well beyond financial difficulty or losses that are of a passing nature (no matter how severe they might be at the time). Instead, the fine must contribute to a risk of immediate bankruptcy.
- *Secondly, it is necessary to show that bankruptcy of the firm concerned would have socially damaging consequences.* Both the Tokai Carbon case (Court of First Instance, 2004) and Copper Plumbing Tubes (European Commission, 2004a) affirm the second leg of the test – i.e. that the consequences of the bankruptcy should be regarded as socially damaging. Tokai Carbon notes the following regarding the undertaking’s “real ability to pay”:

*That ability applies only in a ‘specific social context’ consisting of the consequences which payment of the fine would have, in particular, by leading to an increase in unemployment or deterioration in the economic sectors upstream and downstream of the undertaking concerned.* (Court of First Instance, 2004:par. 371)

Thus the social context refers to two aspects: the effect on employment and the effect on industry structure and well-being, particularly upstream and downstream. Tokai Carbon illustrated that social impact goes beyond the well-being of the owners of the enterprise. The CFI pointed out that while the “liquidation of an undertaking in its existing legal form” (Court of First Instance, 2004:par. 372) may adversely affect the owners or shareholders, it is not evidence in itself of a social context. The inference is that the risk of an immediate bankruptcy would meet the second leg of the test if it would result in real economic and social consequences – but not if it merely entailed a reorganisation of the financing and ownership of what would remain a going concern.

More recently, the European Commission reduced fines for a number of firms based on an inability to pay and the likely bankruptcies that would result, particularly in light of the economic crisis. While press releases suggest that the European Commission may be taking a softer view, with the inability to pay claims being judged solely on whether the fine would lead to bankruptcy, the press releases also acknowledge that the social and economic context of each firm is examined (European Commission, 2010a and 2010b). Without the full judgements being available it is difficult to assess to what degree the approach of the European Commission has changed (if at all).

Two key observations can thus be made here regarding the “inability to pay” provisions with regard to fines in the EU.

- Firstly, the European Commission does not appear to be concerned about impacts on the profitability of the firm – the implication of this is that the Commission believes that the severe impact on the offending firm should not further disadvantage

industries upstream and downstream (i.e. consumers).

- Secondly, the Commission sets a very high bar for reducing a fine – only fines that result in bankruptcies that are themselves viewed as socially undesirable are considered for a reduction.

A fine that results in bankruptcy (and thus exit) could potentially have severe consequences for consumers in the market and could have distortionary consequences. For this reason, since a clear negative effect is likely to occur only under particular scenarios, the South African authorities may find it reasonable to consider these elements in assessing the potential social impact of a particular fine.

Similarly, although a different context to administrative penalties, what the failing firm defence shows is that the legislation and the competition authorities are not concerned with the exit of firms per se, but rather the impact of competition and thus the impact on consumer welfare.

### 3.2 Impact on investment and entry decisions

An additional argument may be that while the fine may not result in complete exit, it may have an impact on investment and new entry.

In terms of neoclassical theory, an efficient firm should ideally base its capital investment decisions on an assessment of whether potential projects yield a positive net present value when utilising an appropriate discount rate, and whether suitable financing exists. Thus a firm will choose to invest if the benefit from investing a rand is higher than the marginal cost of investing it (including financing costs). Assuming the fine has no impact on the firm's actual ability to finance the investment, the decision on whether to invest or not would not be affected by the *level* of the fine.

Furthermore, a high fine charged to participants within an industry should not have any impact on entry. New entrants *would not be faced with a fine* and this would therefore not be factored into their incentive to invest, relative to the counterfactual of a post-investigation industry without a fine.

It is worthwhile noting that the inability to pay provisions of the EU is not concerned with any potential investment impacts that may affect consumers. There are a number of potential reasons for this, including

- a) that the Commission does not believe there are likely to be any investment impacts that would affect consumers,
- b) that any effects on consumers are unlikely to be substantial and thus not worth protecting against,
- c) that providing for investment effects would compromise the deterrent objective of fines and
- d) that the actual impact would be near impossible to identify.

While the possibility exists that a fine may leave a firm unable to capitalise on an investment opportunity, with alternatives such as the delaying of the investment, raising finance at less favourable terms, or another firm implementing the same investment, it is unclear whether this effect and its potential impact on competition and consumers would be significant.

In conclusion, administrative penalties in very particular situations may affect consumers as well as firms upstream and downstream. The primary example (which the EU has acted to protect

against) is one of a bankruptcy if it results in negative impacts on consumer welfare. There may also be an effect on investment decisions. However, these would occur only under very particular circumstances, and are unlikely to be a widespread phenomenon.

## **4. ALTERNATIVE FINING METHODS – PAYMENT THROUGH LOWER PRICES**

Since administrative penalties are largely not seen as distortionary under ordinary circumstances, it is useful to examine the potential for distortions that arise through alternative fining methods that may be seen as beneficial from a social perspective. This is particularly relevant given that the recent consent order reached with Sasol suggests greater scope for specific behavioural remedies instead of administrative fines (Competition Commission, 2010b). We consider the example that has been discussed to some extent in the press and by Cosatu, namely that that companies guilty of abuses could potentially pay their fine back to consumers through a lower price or rebate. This would allow consumers to benefit from the payment of the fine in a more direct manner. The concept would simply be to ask firms to reduce their prices for a period until the point at which foregone profits equate to the level of the administrative penalty. We show that under certain conditions this could potentially create more distortions in the market than an ordinary fine.

### **4.1 Competitive response to forced price reduction in terms of economic theory**

In terms of the competitive framework developed in section 2, firms in a competitive market generally produce at the level at which marginal revenue equals marginal cost. An additional price reduction would penalise the firm by forcing it to price at a lower level – that is, a level at which marginal cost exceeds marginal revenue.

This mechanism for disbursing fines seems attractive for various reasons. Firstly, it compensates consumers who were affected by the abusive behaviour. This direct redress for customers would typically provide more comfort to those customers than an administrative penalty that goes to the National Treasury. The price decrease penalty plays a redistributive role and increases the consumer surplus while decreasing the producer surplus. Secondly, this method of disbursement could potentially assist the company paying the fine by spreading payments out over a longer period as opposed to a once-off lump sum paid immediately. Depending on whether the firm's discount rate was incorporated into the calculation, the firm could end up paying a lower effective fine as a result.

Lowering prices to equate to the level of the fine seems to be relatively straightforward conceptually. Depending on the structure of the market the firm could

- a) offer discounts directly to final customers (if they sell at a retail level),
- b) sell at discounted prices to wholesale customers with the hope that these declines will be passed through to final customers where relevant, or
- c) structure some type of coupon mechanism if their product is largely an intermediate product and they hope to impact on final consumers.

However, in many of these cases, achieving the purpose in a transparent, measurable and non-distortionary manner is likely to be difficult. In particular, designing a suitable mechanism for implementing and monitoring a price reduction is likely to be challenging. Furthermore, even if a



suitable mechanism for monitoring the fine were developed, a key issue to be resolved would be how to minimise potential unintended consequences. We discuss each of these issues in turn.

## 4.2 Monitoring payment

Designing a suitable mechanism for implementing a price reduction is likely to be more subtle, largely due to the difficulty in designing a transparent, measurable mechanism for monitoring the exact amount paid. This is because even in a competitive environment, prices would naturally vary over a period of time due to changes in demand, input costs and competitor behaviour. For this reason, determining how much the firm has paid is complicated by the fact that the authorities are unlikely to have full information on the price or margin they would have achieved absent the discount.

*For example*, the simplest approach to measuring the amount paid is through identifying what the *counterfactual* price would have been in the competitive market, calculating the difference between it and the actual price charged and multiplying the difference by volume to create an estimate for the amount effectively paid. However, this mechanism is rendered problematic by virtue of the fact that the authorities will not have an easy means of determining if the counterfactual price is indeed correct. Companies could inflate their counterfactual price, which would result in them paying a lower fine in practice. Alternatively, if the authorities believe the counterfactual price has been inflated when in fact it has not been, firms could face the risk that their payment is not acknowledged.

As an alternative a *counterfactual margin* could be identified (e.g. the current margin) and the difference between actual and the counterfactual margin could be measured as payment for the fine. Aside from the obvious problem of identifying the counterfactual margin, this mechanism is problematic in that it eliminates the natural and pro-competitive incentive for companies to increase efficiencies and lower costs in response to a fine in order to try to maintain margins.

Under particular conditions, this could potentially be implemented by distributing coupons to consumers. As not all *coupons* will be redeemed, the market price is still set competitively and forms a counterfactual price. Furthermore, the direct distribution to consumers of coupons that provide a monetary discount is more easily monitored and measurable. Depending on the industry, redeemed coupons will form the basis for a claim by the downstream distributor or retailer, and these claims can be independently audited until the fine is paid off. This mechanism also benefits from ensuring pass-through to consumers.

However, there are some drawbacks to the use of a coupon system. Coupons would be effectively the same as rebates in industries with wholesale, or a few large, customers. As there is likely to be greater redemption of coupons (which in these circumstances would effectively be rebates), it is likely that the company fined would be able to alter the *competitive* price in anticipation of the discount, since it would not need to factor in losing those sales of customers who are not using the coupon or getting the rebate. Coupons are also costly to distribute, and redemption rates are often low, which may lead to the fine being paid off over a longer period of time than is optimal. Furthermore, in many instances coupons require systems for reimbursement and the full acquiescence of downstream companies, which may not always be possible.

For these reasons, it is not clear that there is a simple and effective mechanism for implementing and monitoring the fine in a manner that would be acceptable to both competition authorities and the business fined.

Even if the problems of monitoring pricing and payment could be solved, the authorities would face a separate problem of monitoring quality. Malone and Sidak (2007) show that the competition authorities in the US, in the context of merger remedies, are reluctant to accept commitments not to raise price by the merged entity. One reason for this is that firms can reduce quality instead of raising prices to achieve the same purpose, and such quality reductions are difficult to observe. Thus, while a firm may be charging low prices as a payment mechanism, it may in fact at the same time be lowering quality to maintain margins.

### 4.3 Unintended consequences

The mechanism of paying back a fine through lower prices to consumers differs from an administrative penalty in that it directly alters pricing, and therefore has an immediate impact on market dynamics. While it may temporarily lower prices for consumers, depending on the structure of the market it could impact on the behaviour and competitive dynamics faced by other firms horizontally or vertically. The payment of a fine through pass-through could therefore have various unintended consequences, some of which would have distortionary effects.

#### 4.3.1 Unintended impacts on competitors

The payment of an administrative fine through an unnatural reduction in prices below the competitive level by a single company (or group of companies in the industry) may have the unintended consequence of forcing all rivals to follow with their own price cuts or face declining sales. This is particularly true if products are less differentiated and competition is price-based. While this may seem superficially beneficial, it raises relatively serious concerns of a legal and economic nature in particular circumstances.

- *Firstly*, in being forced to match a price discount that was imposed in lieu of a fine, it effectively imposes the same fine on those companies that were not party to any alleged collusion or were granted corporate leniency. This is likely to be seen as unfair by those companies being inadvertently punished for the actions of others.
- *Secondly*, if more than one company in an industry pays a fine in this manner, even those companies that are subject to a fine themselves could end up paying an effective fine that is larger than their own fine. This would occur under various circumstances:
  - If consent orders are signed at *different times* then there will be no perfect overlap in the period of lower prices. The implication is that once the first firm has completed its repayment, it still cannot raise its prices, because another firm is now repaying its fine. The result is that the first firm will overpay its fine. The same holds for the second firm, which effectively starts paying a fine through lower prices before being officially measured for its consent order.
  - This may also occur if the *size or terms of the discount* (smaller discount over a longer period or sharper discount over a shorter period) differ across companies fined.
  - It would also occur if the *products* against which fines are paid differ for the companies involved or if their product mixes differ.
- *Thirdly*, there is a danger that the cumulative effect of below-competitive pricing for a sustained period, particularly by larger producers, could soften competition in the industry if it resulted in the exit of smaller firms. The extent to which this is a real danger depends on how deep and long the price cuts are imposed for. Arguably there

may also be a reduction in entry and/or investment in the sector for this period of repayment by new entrants as margins decline.

Finally, in situations in which the post-discount cost is below marginal cost, there could be the bizarre situation that a firm complying with the Competition Commission's consent order is technically in violation of the Competition Act through predatory pricing.

#### **4.3.2 Unintended impacts in downstream markets**

Where the products involved in this case are upstream or intermediary products, the repayment of a fine through lower pricing could create distortions in the downstream markets.

For instance, if competitors in the industry do not match their price decreases then the wholesale customers of these rivals would face a price disadvantage relative to customers of the fined firm. This could have an impact on downstream companies similar to that of price discrimination, particularly if there are high switching costs, supply agreements or capacity constraints that would prevent them from switching to the lower-priced offer.

In instances in which the firm distributes on wholesale and retail level, where the terms of the fine require the company to discount downstream, we could also get the situation that a firm complying with the fining mechanism is technically in violation of the Competition Act through, for instance, margin squeeze.

#### **4.3.3 Impact on customers**

In instances in which a firm provides an intermediate input, it generally has limited control over the extent to which its customers pass these lower prices through to final customers. Pass-through to final customers may be substantially limited in instances in which a firm supplies its products

- a) internally to its own downstream operations, who then supply consumer products to retailers,
- b) on a wholesale basis to industrial customers, who use it as an input into their own product range.

Economic theory indicates that the extent of pass-through of lower costs to prices depends on a host of factors, including

- a) whether marginal or fixed costs are impacted, and
- b) the nature of the own demand function for that firm – economic theory shows that prices are determined by production occurring where marginal revenue (determined from the demand function and competitive conditions) equals marginal cost.

However, it is only in specific circumstances that we would expect full-cost pass-through to occur. Additional complications are

- a) the temporary nature of these cost reductions, which may inhibit some firms from responding with lower prices if there is natural resistance to increasing prices later from their customers, particularly if there are menu costs, and
- b) for some customers the product is a minor input into final price, which is likely to result in no meaningful response at all.

Thus, while an alternative mechanism for disbursing a fine, such as a price pass-through, has

some attraction, the benefits may be limited in some instances, as the pass-through creates a far greater level of distortion in the market than a once-off administrative penalty, and in many instances may not have the full effect desired.

## 5. CONCLUSION

This paper critically discusses some of the common comments made by both business and the public in the face of high fines. Our preliminary research suggests that the concerns that have been raised in the press appear to be largely unfounded.

- *Firstly*, administrative penalties would not lead to higher prices for consumers, as the large fines would generally not impact the optimum pricing levels of a firm.
- *Secondly*, only in very specific circumstances would an administrative penalty lead to firm closure and result in undesirable consequences for social and consumer welfare.
- *Thirdly*, while the proposed alternative mechanisms for disbursing fines (such as a price pass-through) hold the attraction of directly benefiting affected consumers, the potential benefits may be limited under circumstances in which these mechanisms create additional distortions in the market, to the detriment of consumers, downstream industries and even competitors who did not engage in the prohibited conduct.

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