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Mechanisms of Governance in the energy and related sectors: a Russian antirust case study

(Do we need remedies from Hostility Tradition?)

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One recent extra-ordinary antitrust case in Russia

- …demonstrates the hostility tradition is still alive?
- …antitrust bans are not applicable?
- …shows that our knowledge on economic organization is insufficient?
- …appeals to draw the lesson for the future.

Hostility tradition in antitrust…

«One important result of this preoccupation with the monopoly problem is that if an economist finds something—a business practice of one sort or other—that he does not understand, he looks for a monopoly explanation. And as in this field we are very ignorant, the number of ununderstandable practices tends to be rather large, and the reliance on a monopoly explanation, frequent»

[Coase, 1972]

…in details

1. Focus: level of **market concentration** and **entry barriers.**
2. **Easy antitrust enforcement** without taking into account of estimates of cases from welfare perspective based on all relevant and meaningful information.
3. Belief that **collusion is easily created and enforced**.
4. **Entry barriers are anticompetitive and antisocial phenomena**
5. The **firm** is adequately described as **production function** with purpose to maximize profit

[Williamson, 1985]

The present study applies tools of the New institutional economics (NIE) in order to examine…

the problematic inter-relationship between contracting (institutional arrangements) on the one hand,

and antitrust/industrial policy in areas which despite their importance for Russian economy (and, probably for some big players in Europe),

researchers *know extremely little about*.

Main ideas are presented in…

- Shastitko A., Golovanova S. *Collusion in Markets Characterized by One Large Buyer: Lessons Learned from an Antitrust Case in Russia* // Higher School of Economics Research Paper No. WP BRP 49/EC/2014, downloadable http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2392222
- Shastitko A., Golovanova S. *Competition Issues Regarding Procurements for Large Companies and Suppliers: The Gazprom Case* // CPI Antitrust Chronicle, November 2013 (2)

Large Diameter Pipers

The Case against all biggest Russian LDP producers and “traders” of large diameter pipes (LDP):

CJSC “TD TMK”, OJSC “OMK-Stal”, CJSC “ChTPZ Group”, CJSC “ITZ”, OJSC “ChTPS”, CJSC “TD Uraltrubostal”, CJSC “OMK”, and OJSC “VMZ” (2011-2013).

The main result of Federal Antimonopoly Service of Russia (FAS) sunrise raid:

schedules of LDP delivery by all Russian producers for OJSC Gazprom projects signed by representatives of all producers

The core of initial accusation by FAS:

collusion, namely: market sharing where LDP have been produced mainly for large investment projects (Gazprom and Transneft) realization

Comments:
Prohibited by law "On competition protection" (clause 3, part 1, art. 11)
Perspectives for companies and CEOs:
fines (up to 15% year market turnover according to art 14.32 of Russian Administrative Code) for company and criminal sanctions (up to three year imprisonment according to art. 178 of Russian Criminal Code)

Arguments of the Russian FAS

(1) there were idle capacities,

(2) the threat by imports was minimal,

(3) a small number of market participants (and no new Russian participants) had appeared in the LDP market in recent years,

(4) <u>documents</u> that described the issue of developing and meeting delivery schedules for pipes.

De we have universal indicators for collusion identification?

- excess capacities *[Davidson and Deneckere, 1990]*,
- price-cost margin *[Jans and Rosenbaum, 1996]*,
- descriptive statistics for price dynamics [Abrantes-Metz et. al. 2006; von Blanckenburg et al, 2012],
- market-share stability *[Geist and von Blanckenburg, 2011]…*
- *…and results are often umbiguous (*comparative analysis of the results of empirical studies, see *Porter [2005]* and *Levenstein and Suslow [2006]*)

Theoretical support in detecting markets with a high risk of cartel formation (correlates with FAS arguments)

- small asymmetry in company capacities *[Compte et.al. 2002];*
- stable and growing demand *[Staiger and Wolak 1992; Mendi and Veszteg, 2009];*
- high entry barriers, including import protection *[Sutton, 1991, 1998; Symeonidis, 2002].*

…But what has happened before?

- Deal of the century: “gas - pipes” (last third of the XX century)
- Almost no Russian capacities for LDP production
- Political decision to develop LDP capacities
- Private investment in new sub-industry

Negative effect on public welfare

Main investment projects in the LDP segment in 2005 -2010

Project	Operator	Implemen-tation (year)	Investments ($ million)	Annual capacity
Two LDP lines	OMK	2005	310	1,600,000 t
LDP workshop	Severstal	2006	300	600,000 t
VMZ capacity addition	OMK	2008	190	+380,000 t
VTZ capacity addition	TMK	2008	214	+650,000 t
Vysota 239	ChTPZ	2010	900	900,000 t

One large buyer

The procurement process is largely controlled by the OJSC Gazprom group (more than 50% of electric-welded LDPs sold in Russia)

- The economic nature of collusion in any market should exclude the participation of the buyer given that any agreement goes against its best interests
- The existence of a countervailing force creates obstacles to the qualification of the dominant positions of sellers in the market

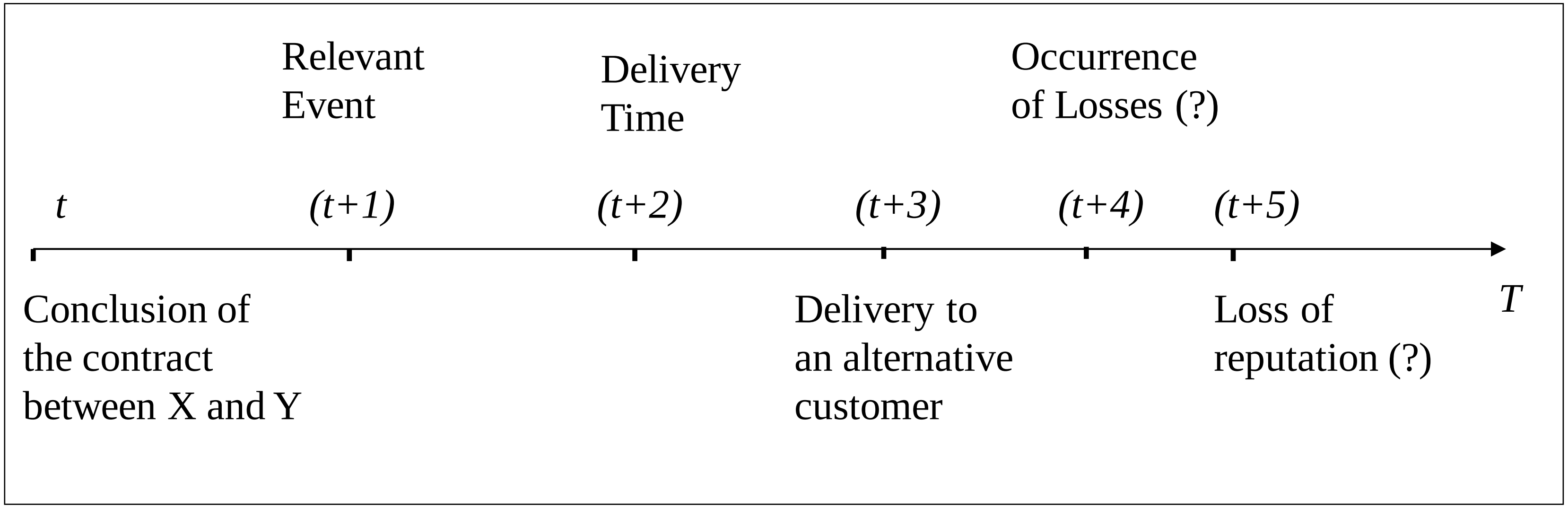
High uncertainty

- The significant duration of the production cycle,
- The high cost of manufacturing products,
- The volatility in both the supply conditions for the materials required to produce LDPs and the demand from the major consumers…
- and … significant switching costs.

Temporal specificity

- Use of Tender Procedures
- Existence of infrastructure that allows to accumulate LDPs in significant quantities

Contracting Timeline

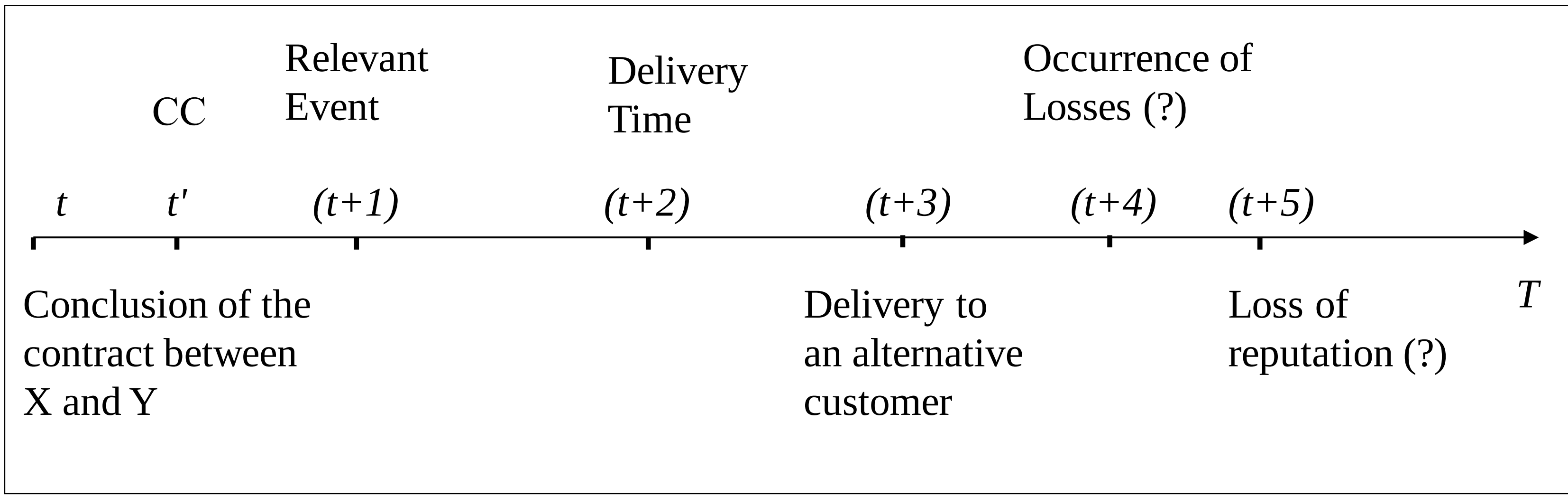


Credible commitments

Alternatives available for the Company X (reminding contracting schemata *Williamson, 2002*):

- Decide against manufacturing product Q;
- Do not take precautions and directly include the company's own risk estimates in the product price;
- Integrate X and Y (i.e., create control relationships);
- Preserve the independence of X and Y (i.e., no control, separate residual rights) but use a package of contractual precautions in order to retain the credible commitment for X.

Timeline of Contracting with Credible Commitment



The practical solution to the problem of credible commitments: structural alternatives (1)

- A medium- to long-term indicative planning instrument.
- Procurement and supply procedures for LDPs with an allowance for the strip material order and delivery cycle and production of LDPs from such strip material.
- Long-term negotiated contracts between OJSC Gazprom and LDP manufacturers.

The practical solution to the problem of credible commitments: structural alternatives (2)

- Utilization by LDP manufacturers of financial instruments to insure their risks.
- Direct state regulation.
- Joint venture between pipe manufacturers and consumers in order to develop and commercialize new products

- The investigation of the interaction between LDP manufacturers and OJSC Gazprom provides grounds for considering it to be a form of indicative planning.
- From this perspective, LDP competition is not being squeezed out, but rather the partial substitution of the price mechanism is occurring through alternative methods of organizing the interaction between LDP manufacturers and OJSC Gazprom…
- *hostility tradition - policy dis-coordination - subordinated antitrust?*

Lessons learned

- Importance of information exchange in production arrangements for complex investment projects and under countervailing buyer power in interpreting the impact of the agreement on competition.
- When interpreting coordination of delivery plans as an evidence of collusion among sellers it should be analysed whether they exceed the scope required for the successful implementation of complex construction projects with high level of time- and site assets specificity.

Lessons learned

- In the long-run and in case of risky investments projects cooperation among suppliers can bring efficiency gains even without improvement of production and/or technology, derived from economizing on transaction costs.
- Efficiencies of risk management seem to be necessary to assess as important incentive for information exchange and coordination not generally related to collusion.

Thank you for attention!

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