

The Automotive Cartel Investigation First Lessons for the Future

**Fair Trade Center
29 May 2012**

Presented by:

Marc Hansen

Niall Lynch

Daisuke Yoshida

Why this topic today?

- Two years into global automotive antitrust investigation
 - This is the largest antitrust investigation ever
 - It affects much of the automotive industry and the supply chain
- The cases will continue for years and will have a substantial impact on the industry
- Because lead times in the auto industry are long, now may be a good time to start identifying risk factors
 - taking account of sensitivity and confidentiality concerns
 - looking objectively at industry structures, without suggesting blame
- By identifying risk factors, lessons can be learnt for the auto industry and for other industries

The evolution of the Automotive Cases

- The automotive industry investigation shows the success of the leniency systems across the globe
- Immunity and amnesty applications
 - Supplier 1 of Product A
- Amnesty Plus application in US
 - Supplier 2 makes Products A and B
 - Supplier 2 leads to investigation of Product B
 - Supplier 3 leads to investigation of Product C, etc..
- Global coordination by authorities and leniency applicants
 - Cases spread across US, EU, UK, Canada, Japan
 - Indications of investigations in Australia
- For a global industry, it has become a global problem

The cases have spread like a wildfire across the industry

- News reports indicate broad scope and many investigations
 - Wire harness and electrical components
 - Safety equipment (seatbelts; airbags etc)
 - Alternators, starters, ignition parts and electronics
 - Automotive electronics and electrical systems
 - Navigation and entertainment
 - Automotive ball bearings
 - Catalytic converters and related parts
 - A month ago there were reportedly more than 150 products under investigation; there are perhaps more by now
 - Where does it end?
- Who is affected by the investigations?
 - Who is not involved – very few?
 - Who is not affected – no one?

What is the impact?

- Impact depends on the jurisdiction, but the combined impact is substantial:
 - Already hundreds of millions of USD in fines, which will be billions by 2012-13 when EU and other fines are imposed
 - So far 9 executives have agreed to serve jail sentences
 - Massive cost and disruption of business, while executives in Japan, Europe, United States and elsewhere prepare their defence
 - Even before damages actions start in other countries, already many class actions in the United States
 - Business environment is uncertain

The US case has been the most public

- **Automobile parts investigation in the U.S.**
 - AAG Pozen: “largest criminal investigation the [DOJ] has ever pursued”
 - Aggressive and successful use of Amnesty Plus
- **Five companies charged and fined US \$760 Million**
 - Furukawa, Yazaki Corp., Denso Corp., G.S. Electech, Fujikura
- **Nine individuals have agreed to serve jail time in the US**
 - Sentenced to between 12 and 24 months in jail
- **Products involved**
 - Charges on wire harnesses, electronic control units, heater control panels
 - Dozens of other products under investigation
- **Charged conduct**
 - Allocation on a model-by model basis, bid rigging, complementary bidding, price coordination on APRs, and price fixing on auto parts, principally sold to Japanese auto manufacturers

Other jurisdictions are also advanced

- The JFTC steps to date indicators of direction?
 - Largest fine ever in JFTC bid rigging decision (*Wire Harness*)
 - Automotive sector also the subject of criminal investigation
- The EU case has largely mirrored the US investigation
 - EU conducted dawn raids/ RFIs in many product markets
 - EU fine-tuning the scope of each investigation in order to ensure leniency benefits accrue to applicants
 - Aim to resolve most of the cases through settlements?
- UK criminal investigation was closed
 - UK OFT arrested and investigated individual in auto cases
 - Investigation dropped, in part because of procedural interplay with EU investigation in automotive area

More to follow?

- Canada well advanced with “more than 164 leniency markers” and a reported 150 products covered in affidavits to Canadian courts
- Australian investigation reported in *Automotive News*
- Will other major enforcement jurisdictions join in? (Brazil has been in all the recent global cases and has a substantial automotive industry)
- Does it stop there?

So why did it happen ?

- Before drawing lessons, it is important to understand why this case happened
- These cases are different from most “classic” cartels
- Common feature identified in public documents is that conduct is linked to procurement practices of customers
- Procurement practices very similar across auto industry
- With thousands of parts being purchased, there is a potential for thousands of investigations

Why the automotive industry?

- Why this industry?
 - Procurement patterns by automotive companies
 - Competitive RFQs, but few and same qualified bidders in each round
 - Qualification to supply operates as barrier to entry for suppliers
 - Collaborative development/cost concerns in R&D phase
 - Target prices and price pressures from OEMs reduce importance of other competitive parameters
 - Annual cost reduction targets communicated to all at same time
 - Qualified suppliers under pressure to bid, or lose qualified status
- Each of these are factors which appear to have influenced conduct in the industry

“Changing hats” of auto industry suppliers

- Customized products, suppliers requiring know-how of customer production and procurement processes
- Extensive co-development by suppliers working with OEM customer’s procurement department
- Varying nature of relationships
 - Tier 1 and Tier 2 one day,
 - bidding jointly another
 - competing a third day
- Major suppliers know one another at various levels

Competitive bidding, but among few

- Request for quotations issued to a few suppliers
- Multi-stage supplier selection, with elimination of bidders in phases
- Competitive bidding the norm for +20 years
 - Competitive RFQs, but few qualified bidders
 - ...i.e., high concentration for each bidding “submarket”
- The effect of a small number of suppliers focused on price at the same time
 - Communications do not have to be very detailed to reduce uncertainty, and that is enough for a violation of antitrust law

Contestability / barriers to entry for suppliers

- Each customer selects a limited number of suppliers for each type of component
- It takes years to get qualified and win access to supply contracts
- Contracts are long and little opportunity to contest between multi-year events
- Entry attempts are risky and displacement of suppliers is rare, leading to an environment where existing suppliers are inherently protected from competition

Collaborative development / Cost concerns in R&D phase

- Collaborative development and R&D is an essential part of the auto industry
- It is also a key feature of Japanese society and industry
- Significant benefits in sharing knowledge of suppliers and drawing them into planning
- Information exchanges are part of procurement process
- But mixing joint R&D activities with cost demands creates a dangerous environment

Other pressure points

- Target prices of customers reduce effectiveness of other competitive parameters to distinguish suppliers
 - Innovation is key, but early in the competitive process
- Annual cost reduction targets and negotiations
 - Customer communicates cost reduction targets to all suppliers at same time and with similar mechanisms
- Qualified suppliers under pressure to bid, or lose status
 - Customer insists that supplier submits bid, even if outcome is predetermined – is that an unnecessary risk?

Is auto industry procurement a particularly dangerous environment?

- DOJ identifies risk markets with the concept of “red flags of collusion” and factors conducive to collusion:
 - few sellers, five or less
 - products where the ultimate decision by the customer is based primarily on price
 - high barriers to entry
 - repeat purchases or bidding events (competitors get to know each other and can share the work); and
 - contacts, or opportunities for contacts, between competitors.
- All five factors can be found in automotive procurement

What are the most obvious lessons?

- Cases can spread widely and quickly, and are very costly and disruptive of business
- Lessons for suppliers:
 - There are substantial risks
 - Even where conduct appears benign, there may be risks (information exchanges in collaborative ventures)
 - Risk of investigation based on single communication with competitor
- Lessons for customers
 - Auto companies' procurement processes
 - Work with suppliers to minimize risk of collusion
 - Separate commercial and technical functions

Risk management

- Risk management goes beyond what is required to be compliant with the law
- The practical questions at this point:
 - What steps can suppliers take to manage risks?
 - What steps can customers take to minimize risk?
- Effective risk management is likely a shared issue

How can suppliers manage risks?

- Strong compliance with antitrust laws is an essential starting point, but it is not enough to eliminate exposure
- This is also about suppliers' internal organisations – e.g., the role of the sales departments vs. planning/development departments
- Risk management requires analysis of the “changing hats” of suppliers -- competitors on some sales, but collaborating on others
- Increased care on collaborative R&D projects etc (clear written rules & separating pricing and cost from technical development)
- Increased involvement/awareness of customers (OEM or Tier 1) to ensure that suppliers are not exposed to excessive risks

How can customers minimize risks?

- Some issues are within the exclusive control of the customers
 - Ensure needed supplier technical collaboration, but limits spill-over effects on commercial issues
 - Do not involve sales functions in purchasing roles? In joint R&D efforts?
- Increase role of non-price parameters at critical junctures of the supplier selection process (innovation & quality at same time as price)
- Involve customers in supplier collaboration to allow informed decisions about which information can be shared between suppliers
- Where joint development or mixed horizontal/vertical relationships are necessary to achieve benefits, greater acceptance that price information may spill over and affect situations where joint suppliers are competitors
- Are there ways to use the multi-stage procurement process to reduce (even more than now) any spill-over effects of supplier collaboration?

Lessons for other industries

- Antitrust authorities have learned a lot from the automotive investigations
- Case focused on issues with heterogeneous products (non-commodity)
- Focus on information exchanges / understandings that flow from specific market structures (e.g., created by a particular procurement process)
- Other industries have multi-level and complex procurement patterns with significant joint development issues
 - Industrial equipment
 - Transportation and aerospace
 - Electronics industries
- Spill-over issues risks not very different from those in chemical and heavy industries where there are shared costs, shared facilities, common inputs
- The primary lesson is strict compliance, but also focus on risk factors arising from procurement processes and market structures

For further information:

For further information please contact:

Marc Hansen, Partner

Latham & Watkins, London & Brussels

<http://www.lw.com/people/MarcHansen>

Niall Lynch, Partner

Latham & Watkins, San Francisco

<http://www.lw.com/people/NiallELynch>

Daiske Yoshida, Partner

Latham & Watkins, Tokyo

<http://www.lw.com/people/DaiskeYoshida>

Slides and other materials on this topic may be downloaded from the “Presentations” tab under each biography listed above