ANTITRUST SANCTIONING IN CHINA: HOW CAN THE NDRC GUIDELINES BE FURTHER IMPROVED

BY JET DENG[1] & YANNIS KATSOULACOS [2]

I. INTRODUCTION

In recent years there has been a lot of discussion about the need to revise the antitrust sanctioning systems in force in a number of countries and make them more effective, especially in view of the continuing empirical evidence showing that cartels[3] are still very active throughout the world and pervasive in a variety of markets.[4] Monetary penalties and other sanctioning methods are recognized as one of the most important policy instruments in the enforcement of competition law.[5]

As an outcome, in a number of countries, there have been moves by policy makers to reconsider their sanctioning regimes. In this article we consider the case of China,[6] where Draft Guidelines issued by the National Development and Reform Commission ("NDRC")[7] in 2016, have re-affirmed the importance of taking into account of illegal gains (disgorgement) in the

1 Senior Partner, Beijing Dentons Law Offices, LLP. Email: zhisong.deng@dentons.cn.

2 Professor, Department of Economics, Athens University of Economics and Business. Email: ysk@hol.gr.

3 Below, following existing literature, we concentrate on fines to cartels / collusive agreements.

4 See, Levenstein & Suslow (2011), "Breaking Up Is Hard to Do: Determinants of Cartel Duration," *Journal of Law and Economics* 54, 455 92; Levenstein & Suslow (2012), "Cartels and Collusion: Empirical Evidence," Ross School of Business Paper No. 1182, available at: http://ssrn.com/abstract=2182565; Marinielo (2013), "Do European Fines Deter Price Fixing?," VOX CEPR's Policy Portal; Connor (2015), "EU Cartel Penalties: Severity and Recovery: With International Comparisons," presentation in the Conference "Looking beyond the direct effects of the work of Competition Authorities: Deterrence and macroeconomic impacts" organized by Netherlands Authority for Consumers and Markets, UK Competition and Markets Authority and the European Commission ("DG COMP") in Brussels, September 2015, available at: http://ec.europa.eu/competition/information/macroeconomy/connor_en.pdf.

5 See, Ginsburg & Wright (2010), "Antitrust Sanctions," *Competition Policy International*, vol. 6 (2), pp. 3-39; Harrington (2010), "Comment on Antitrust Sanctions," *Competition Policy International,* 6, 41-51; Harrington (2014), "Penalties and the Deterrence of Unlawful Collusion," *Economics Letters*, vol. 124, pp. 33-36; Houba, Motchenkova & Wen (2010), "Antitrust enforcement with price-dependent fines and detection probabilities," *Economics Bulletin*, 30(3), 2017-2027; Houba, Motchenkova & Wen (2012), "Competitive Prices as Optimal Cartel Prices," *Economics Letters,* 114, pp. 39-42; Bageri, Katsoulacos & Spagnolo (*BKS*, 2013), "The Distortive Effects of Antitrust Fines Based on Revenue," *The Economic Journal*, 123 (572), 545-557; Katsoulacos & Ulph (2013) "Antitrust Penalties and the Implications of Empirical Evidence on Cartel Overcharges," *The Economic Journal*, 123 (572), 558-581.

6 Among the many countries that have in recent years seek to revise their sanctioning policies are Chile, Japan, South Africa and UK.

7 In China, it is the responsibility of the Anti-Monopoly Commission ("AMC") under the State Council to promulgate antitrust guidelines. In practice, the AMC usually assigns the drafting work to certain anti-monopoly enforcers, and will review and finalize the draft ultimately. In the case of the antitrust guidelines on illegal gains and penalties, its drafting work is assigned to the NDRC.

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setting of monetary penalties, appearing to create a presumption that disgorgement would apply in nearly all cases as long as relevant data are available,[8] *in addition* to traditional surcharges based on revenue. While we think that it is important to commend the NDRC for this re-focusing on the deterrence impact of its sanctioning policy, in this article our objective is to suggest an alternative penalty regime that is superior to one that combines revenue-based and illegal gains-based fines, by being easier to implement and being superior in terms of its welfare properties and in terms of legal certainty. Specifically, these penalty regimes can be improved by adopting an alternative regime in which the penalty *base* is that of revenue (as under the standard revenue-based regimes) but in which the penalty *rate* is determined by (and is increasing with) the cartel's overcharge rate[9] – where the latter is much easier to estimate than "illegal gains."

Economists have in the past concentrated on a comparison of the welfare properties of different penalty regimes. While this comparison is very important in identifying regimes that are superior in terms of their welfare impact, in order for the comparison to have policy significance, that is in order to guide policy makers in making choices of the sanctioning policy that should be adopted by competition authorities, a number of other policy-relevant dimensions of the regimes have to be assessed and compared. Specifically, a complete comparison has to take into account the following three dimensions/ assessment criteria:[10]

(i) Implementability

(ii) Legal Certainty, and

(iii) Welfare properties

We start with a review of the antitrust sanctioning regime implemented under the Anti-Monopoly Law in China since 2008 and of the recently proposed Guidelines. We then discuss the lessons that emerge from the recent economic literature concerning which sanctioning policies are best, judged on the basis of the above three criteria, in order to recommend how the Guidelines can be improved further for the benefit of antitrust sanctioning policy in China.

II. REVIEW OF THE ANTITRUST SANCTIONING REGIME AND THE DRAFT GUIDELINES

A. The Situation between 2008 – 2015

Article 46 of the Anti-Monopoly Law of China regulates the legal liabilities of undertakings that reach or implement monopoly agreements and, specifically, the type of penalties that can be imposed by the antitrust enforcement authorities. The latter shall instruct undertakings which implement monopoly agreements to discontinue the violation, confiscate undertakings' illegal gains and, in addition, impose undertakings a fine of not less than one percent but not more than 10 percent of its sales achieved in the "previous year."

According to the Report on the Administrative Enforcement of Anti-Monopoly Law in China (2008-2015), of the 190 cases that had been investigated by the NDRC and the local development and reform commission or price supervision department, 154 cases relate to horizontal monopoly agreements, 21 cases relate to vertical monopoly agreements and 7 relate to abuse of dominant market position. According to the statistics, in only 8 cases illegal gains confiscations were

8 However, Wong-Ervin, Ginsburg, Slonim, Kobayashi & Wright (2016) "Monetary Penalties in China and Japan," GMU Antonin Scalia Law School, DP 16 – 40, criticize the NDRC's Draft Guidelines for the optional use of economic analysis in calculating illegal gains. The authors submitted comments to the NDRC on the Guidelines (Kobayashi et al. (2016), Comment of the Global Antitrust Institute, George Mason University School of Law, on the Proposed Revisions to the Guidelines of the Anti-Monopoly Commission of the State Council on Determining the Illegal Gains Generated from Monopoly Conduct and on Setting Fines (July 9, 2016), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2807321; comments provided an overview of the economic analysis of penalties and advocate for the adoption of a penalty system more closely aligned with economic principles.

9 The proportional excess of the cartel price above the competitive price that would have been established in the absence of the agreement. For example, assuming that the competitive price is $100 and the cartel price is $110, the cartel's overcharge rate will be 10 percent ((110-100)/100=10 percent).

10 Illegal gains estimation requires knowledge of the overcharge and much more - see also below.

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imposed by the authorities on the lawbreakers.

In turn, 101 cases had been investigated by the State Administration for Industry and Commerce ("SAIC") and the local administration for industry and commerce, 87 of which relate to horizontal monopoly agreements and 14 of which relate to abuse of dominant market position. According to the statistics, in 20 cases illegal gains confiscations were imposed.

Thus, while Article 46 of the Anti-Monopoly Law requires authorities to impose illegal gains confiscation and revenue-bases fines at the same time, in the vast majority of cases we do not find the imposition of illegal gains confiscation. NDRC's internal rules (Provisions on Regulating the Authority of Price-related Administrative Penalties), only provide some general aggravating, extenuating or mitigating circumstances to be considered in fine determination. Although the SAIC adopted rules on determining illegal gains (Provisions on Determining the Illegal Gains in Cases with Administrative Penalties), these rules are not tailored for antitrust enforcement.

B. Reasons for the Limited Imposition of Illegal Gains Confiscation

1. Difficult to Estimate

Based on the SAIC's current internal rules, authorities need to calculate the revenue generated from illegal conduct and subtract incremental costs incurred, an approach that is very difficult to be implemented in practice. To give an example, in the compound reserpine *APIs* case in 2011, the NDRC confiscated the illegal gains of two pharmaceutical companies but did not explain how it determined the amount of illegal gains. As mentioned above, in many cases illegal gains were not practically confiscated by the competition authorities.

2. Easy to Challenge

Estimating illegal gains requires a large amount of information and every single piece of incorrect information would lead to an incorrect estimate. Thus the outcome of illegal gains calculation can be challenged in many ways.

C. The Draft Guidelines on the Determination of Illegal Gains and Fines in Relation to Undertakings' Monopoly Conduct[11]

On June 17, 2016, the NDRC published the Draft Guidelines on the Determination of Illegal Gains and Fines in Relation to Undertakings' Monopoly Conduct ("the Draft Guidelines"), which are expected to be introduced formally this year. Once adopted, the Draft Guidelines will represent a significant step towards a more consistent and transparent approach to antitrust fine calculation, bringing the Chinese antitrust enforcement regime closer to its international counterparts. The Guidelines propose a three-step process for fines calculation as follows:

(i) Step one: identify "sales." The Guidelines clarify how the "previous year"[12] sales and the territorial scope of the sales[13] will be determined and how the undertakings will be identified.[14]

(ii) Step two: decide the fine rate based on the circumstances of the conduct. The Draft Guidelines propose a 1-3 percent starting point ("Initial Proportion") depending on the type of conduct. The Initial Proportion will be increased by

11 https://globalcompliancenews.com/china-antitrust-consultation-new-clearer-penalty-guidelines-20160727/.

12 The Draft Guidelines clarify that the previous year is the year prior to the launch of the investigation. If the infringement has terminated before an investigation is launched, the "previous year" is the last year prior to the termination of the infringement.

13 The NDRC and the SAIC generally takes the sales of the products in the geographical area covered by the conduct. If the geographical area concerned is larger than the territory of China, the regulators generally take the China-wide domestic sales of relevant products as the basis for calculating fines.

14 The NDRC and the SAIC generally fine the undertakings who directly implement the monopolistic conduct. However, the Draft Guidelines make clear that the NDRC/SAIC may impose fines on, and in respect of, a parent company, provided that the parent company can exercise decisive influence over a firm which has engaged in the conduct.

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one percent for each year of the infringement, and 10 percent will be the maximum limitation.

(iii) Step three: final adjustments

The Draft Guidelines grant the antitrust authorities the ultimate discretion to make a final adjustment to the Initial Proportion of fines if they consider the percentage concluded from the above steps does not adequately reflect the severity of the infringement.

Adjustments due to aggravating circumstances

Aggravating circumstances	Adjustment
Playing a leading role in the, coercing or inviting other undertakings to implement the conduct or preventing other undertakings from discontinuing the conduct	+1%
Committing multiple infringements in the same case, or having infringed the AML in the past	+1%
Actively compelling or facilitating administrative authorities or organizations to eliminate or restrict competition through abusing administrative power	+1%
Continuing the conduct after being ordered to stop by the antitrust authorities	+0.5%
Other aggravating circumstances	+0.5%

Adjustments due to mitigating circumstances

Mitigating Circumstances	Adjustment
Being coerced by other undertakings to implement the conduct	-1%
Being forced or coerced by administrative authorities or administrative organizations to implement the conduct	-1%
Cooperating with administrative agencies in the investigation and making meritorious contribution	-1%
Actively eliminating negative consequences of infringements	-1%
Actively mitigating negative consequences of infringements	-0.5%
Voluntarily providing relevant evidence of other undertakings' violation of the AML (outside of the scope of leniency)	-0.5%
Other mitigating circumstances	-0.5%

The percentage after the final adjustment should still be within the following ranges: for severe infringements, the proportion after the final adjustment should not be less than 6 percent; for infringements which do not cause significant damage to competition/consumer welfare, the proportion after the final adjustment should not exceed 3 percent.

The Draft Guidelines suggest that the final proportion of fines should never be less than one percent, except where an undertaking has received a whole or partial reduction having sought leniency or where the infringement is not severe, lasts no more than one year, involves at least two mitigating circumstances and where there are no aggravating circumstances.

D. Illegal Gains Calculation

The Draft Guidelines define the illegal gains as the additional profits earned from the monopoly agreements[15] during the period of the illegal conduct.

15 The Guidelines also cover the case of agreements that lead to a monopsony. Also, note that they are meant to apply not only to agreements but also to abuse of dominant market power.

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1. Territorial Scope

In general, antitrust regulators only confiscate illegal gains generated from undertakings' economic activities within the territory of China. What's more, the territorial scope may be narrower, in the case of monopoly that only affects local or regional markets within China.

2. Calculation

According to the Guidelines, if the undertakings obtain additional incomes from the monopoly conduct, Illegal Gains equal to Actual Income minus Hypothetical Income. Actual Income means the incomes actually earned during the period that the monopoly conduct lasts. The amount of actual income can be determined by reference to the undertakings' financial records. Hypothetical Income refers to the income that the undertakings could have obtained in the relevant market if there were no monopoly conduct during the period concerned.

III. LESSONS FROM THE RECENT ECONOMIC LITERATURE AND A RECOMMENDATION

Recent economic literature[16] shows that the designs of monetary penalty structures usually employed at present for antitrust violations, in jurisdictions throughout the world can be significantly improved.

According to the traditional economic view, to obtain efficient deterrence of hard-core cartels, fines should be based on an estimate of illegal gains.[17] Penalties based on illegal gains were early identified for their desirable welfare properties and their adoption was proposed most forcefully by Lande (1982)[18] as appropriate when the enforcing authorities' objective is to deter conduct that does not generate any efficiencies (such as price fixing agreements) in order to avoid the reduction in consumer surplus that results from such conduct. Illegal gains are the cartel's profits over and above the counterfactual level of profits.[19] However, it should be noted that, the welfare properties of these penalties in a second-best world[20] are *not* very good since, for the cartels that form and may remain stable for significant periods of time, they induce cartel prices that are equal to the monopoly level (see *KMU*, 2015 and *BKS*, 2013). Further, it is difficult to estimate accurately illegal-gains based penalties in most cases and their estimation is likely to be subject to quite significant errors. Thus, such penalties have significant implementability problems and can create a significant amount of Legal Uncertainty.[21] Nevertheless, because they are thought to have very good welfare properties through dissuasion of cartel activity they are included, as an additional element of the penalty structures adopted in many countries, though they are very rarely implemented in practice. Thus, according to the current sentencing Guidelines, in the U.S. fines are based on illegal sales (revenue) *and* illegal gains, though in only one case has the imposition of a penalty based on illegal gains been implemented.[22] Similarly, as we saw in the previous section, in China, illegal gains confiscation has been rare up to now.

In contradiction to economists' recommendation that penalties should be based on an estimate of illegal gains, current fining policies in the EU and throughout the world typically base them on affected commerce, i.e. on revenue in the relevant

16 See for example, *BKS* (2013); Katsoulacos, Motchenkova & Ulph, (*KMU*, 2015). "Penalizing Cartels: The Case for Basing Penalties on Price Overcharge," *International Journal of Industrial Organization*, 42, pages 70-80; Katsoulacos, Motchenkova & Ulph (*KMU*, 2016), "Penalising on the basis of the severity of the offence: a sophisticated revenue-based penalty regime," see: http://www.cresse.info/default.aspx?articleID=3388 and the extensive references in these articles.

17 Strictly speaking, an estimate of *expected* illegal gains.

18 Lande (1982), "Optimal Sanctions for Antitrust Violations," *The University of Chicago Law Review*, 50, 652-678.

19 In the special case where the counterfactual price is the marginal cost (competitive price), the illegal gains are the same as the cartel profits.

20 Where penalties are lower than their first best-level of illegal gains weighted by the inverse probability that the illegal conduct is detected and penalized and, therefore, cartels do form and survive for long periods of time. Adopting first-best penalties would violate the legal "principle of proportionality" and would create very significant legal uncertainty.

21 Indeed these seem to have impeded their implementation in the past in countries (such as the U.S. and China) where the Law recommends their adoption.

22 As asserted in a private communication with Yannis Katsoulacos by Greg Werden.

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market.[23] The argument usually advanced for this is that revenue-based penalties have the lowest implementability costs and score well in relation to Legal Uncertainty.[24] On the other hand, as the recent theoretical economic literature has emphasized, revenue-based regimes are very bad in terms of their welfare properties inducing, when their "toughness" is set, so as to generate the same deterrence as other regimes,[25] prices *above* the monopoly level as well as a number of other distortions (see *KMU*, 2015; *BKS*, 2013).

The overall welfare effect of a penalty structure depends both on its pure price effect *and* on its deterrence effect.[26] The prediction, when account is taken of both effects, is that an overcharge-based penalty regime outperforms all the other regimes in terms of average prices, consumer surplus and total welfare (*KMU* 2015). However, as specified in *KMU* (2015), the base of an overcharge-based penalty regime is the percentage price overcharge multiplied by the revenue that would have been earned in the "but-for" situation. Implementing such a base therefore requires estimates of both the overcharge and the counterfactual volume of sales. Obtaining reliable estimates of the overcharge may not be a major implementation problem given how often this is required in damages cases[27] and, importantly for our discussion here, estimating illegal gains. However, estimates of the counterfactual volume of sales is likely to be difficult to obtain and very often at the mercy of legal challenge, on the grounds of their being subject to significant estimation errors.

KMU (2016)[28] examine the properties of an alternative hybrid penalty regime in which revenue is still used as a base but which makes the penalty *rate* increasing in the cartel overcharge. They show that this alternative design (which they call "sophisticated revenue-based penalty") can significantly improve the effectiveness in terms of welfare of the currently employed monetary penalties that are based on revenue with fixed penalty rates. Further, this alternative design is superior to penalties based on illegal gains in terms of welfare impact, by inducing lower cartel prices, while it is also superior in terms of the other two assessment criteria relevant to the comparison, being much easier to implement and by reducing legal uncertainty relative to illegal gains-based penalties. The reason is that while the *sophisticated revenue-based penalty* requires that the Agency forms an estimate of the cartel overcharge, this is also a requirement for forming an estimate of the illegal gains-based penalty, while the latter *additionally* requires information that is difficult to obtain and is easily open to dispute. Specifically, for an estimate of the illegal gains-based penalty one must also calculate how the but-for output and price differ from the output and price corresponding to perfectly competitive situation.[29]

Thus, the suggestion advanced here is that rather than adopting a monetary sanctioning policy combining revenue-based and illegal gains-based penalties, as currently proposed in the NDRC Guidelines in China, both of these penalty structures can be improved by adopting a simpler penalty structure in which the penalty *base* is that of revenue (as under the standard revenue-based regimes) but in which the penalty *rate* is determined by (and is increasing with) the cartel's overcharge rate.[30]

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23 For an extensive, though rather dated review of policies in a large number of countries, see the OECD (2002) report.

24 Penalties are generally calculated as a fraction (the "penalty rate") of a "penalty base" (such as revenues or profits) so the penalty is equal to the product of the penalty base (e.g. revenue) and the penalty rate chosen. Since penalty guidelines only specify that the penalty rate will vary within a range that will depend on a large number of mitigating and aggravating circumstances, there is always some legal uncertainty in predicting the CA's penalty estimate in any specific case. This uncertainty increases as it becomes more difficult to obtain accurate estimates of the "penalty base" and to calculate the appropriate "penalty rate."

25 That is, when they are deterrent-equivalent to other regimes.

26 A number of papers have examined the implications of alternative penalty structures. These include Conor & Lande (2008) "Cartel Overcharges and Optimal Cartel Fines", in S.Waller (ed), *Issues in Competition Law and Policy*, Vol 3, AMA Section of Antitrust Law, Chapter 88, 2203-2218; Harrington (2005) "Optimal Cartel Pricing in the Presence of an Antitrust Authority," *International Economic Review* 46, 145-170; Buccirossi & Spagnolo (2007) "Optimal Fines in the Era of Whistle blowers - Should Price Fixers Still Go to Prison?," in *The Political Economy of Antitrust*, by Goshal & Stennek (Eds.), Elsevier: Amsterdam; Houba et al. (2010, 2012), *BKS* (2013), Katsoulacos & Ulph (2013), *KMU* (2015). In a second-best world many cartels will not be deterred and they may adjust their pricing strategy in response to different penalty structures. So some penalty structures may result in higher cartel prices (and a consequent loss in consumer welfare). The extent of cartel deterrence (and hence the number of cartels that form) is also influenced by different penalty structures – since they affect differently the stability of cartels. This is what is termed the "deterrence effect."

27 See for example Brander & Ross (2006), "Estimating Damages from Price-Fixing," *Canadian Class Action Review*, 3(1), 335-369.

28 Employing the model developed in *KMU* (2015).

29 See for details *KMU* (2016).

30 This rate can be used as the Initial Proportion which is subject to adjustments due to aggravating and mitigating circumstances.

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