Towards an Appropriate Policy for Excessive Pricing

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Introduction

1. In the US, competition law does not cover excessive pricing. In the EU, the Commission has typically exercised its prosecutorial discretion not to take excessive pricing cases, and has often stated that it is not its role to become a price regulator.

2. Nevertheless, there have been strong hints that the forthcoming EC draft guidelines on Article 82 of the EC Treaty will provide guidance on exploitative abuse – which most typically equates to “excessive pricing”\(^1\) – alongside the expected guidance on exclusionary abuse. This clearly raises the issue of what the appropriate policy for excessive pricing should be under Article 82. This brief paper examines this question.

3. The paper sets out the key arguments for and against a relatively laissez-faire approach towards high pricing. A number of conclusions are drawn from this discussion as to an appropriate policy approach to excessive pricing.

4. The paper then argues that, while it may sometimes be appropriate to intervene against excessive pricing, the authorities should wherever possible endeavour to address the causes of the abuse - that is, the market circumstances that allow the excessive pricing to occur - rather than using price regulation to address the symptoms. Such interventions arguably have more in common with consumer policy than with traditional competition policy, but the objective is the same: to improve the functioning of competition, for the benefit of consumers.

5. It should be noted that this paper focuses on exploitative excessive pricing, which is not in itself harmful to the structure of competition in the relevant market. It does not cover situations in which excessive pricing may be exclusionary, such as margin squeeze or constructive refusal to supply. However, it should be noted that in practice many

\(^{1}\) Article 82(2)(a) gives as a specific illustration of abuse: “directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions”. While there has been at least one case based on the unfair trading conditions part of this clause (1998 Football World Cup, 2000 OJ L5/55), cases have more usually revolved around “unfairly high” or “excessive” pricing.
excessive pricing cases are essentially about exclusion rather than exploitation, and moreover the line between the two can sometimes be unclear.²

Arguments for a *laissez-faire* approach to high prices

6. In many jurisdictions, exploitative pricing is either not proscribed by competition law or rarely prosecuted. This reflects the fact that there are a number of arguments against intervening against high prices through competition law.

*High prices may be an important market signal*

7. First, if a dominant firm is earning excessive profits in a given market, this will typically act as an important market signal to attract new entrants into the market. In the absence of substantial barriers to entry, therefore, any intervention that reduces the profits of an incumbent might not only be unnecessary but could actually prolong the monopoly situation by blocking efficient market signals to potential entrants.

8. For this reason, it would be a sensible policy approach not to intervene against high prices if one expects them to stimulate successful new entry within a reasonable period.

*High profits in one market may be given away elsewhere*

9. Secondly, for multi-product firms, or firms in multi-sided markets, it will often be the case that a significant proportion of the “excessive profits” that are made in one market are, in practice, given away in another market. Consider, for example, an electric toothbrush manufacturer, whose toothbrushes are designed so that they can only be used with the manufacturer’s proprietary brush heads. The manufacturer is effectively a monopolist in the supply of its own brush heads, and accordingly will typically price them fairly high. However, so long as the manufacturer faces effective competition in the primary electric toothbrush market, we should expect it to compete much of this “excess profit” away. This will be true even if consumers do not engage in any form of “life cycle” assessment of product pricing.

10. This does not necessarily mean that it will always be inappropriate to intervene against high prices in markets where a substantial proportion of the profits from those high prices are effectively passed back to consumers. In some cases, such a pricing structure may nevertheless be inefficient, for example if the consumers who receive the passed-back profits are not the consumers that pay the high prices, or if the pricing structure substantially distorts consumers’ choices (which can in turn affect the nature and degree of competition).

² For example, the recent *Albion Water* case in the UK, which was argued in terms of excessive pricing, was essentially about the exclusion of a potential intermediate supplier (Albion Water), rather than a straight exploitation case. Competition Appeals Tribunal, *Albion Water Limited v Water Services Regulation Authority*, December 2006, 1046/2/4/04.

11. However, we do mean to suggest that a sensible policy approach would be to refrain from intervening against high prices for one element of a firm’s product portfolio unless careful consideration is given to: the extent of competition the firm faces with respect to the other elements of its portfolio; the extent to which any “excess profits” are effectively returned to the consumer; and the extent to which the pricing structure substantially distorts consumers’ choices.

Assessment of excessive pricing is difficult

12. Thirdly, excessive pricing can be extremely difficult to assess. This is true *ex post* when examining a particular case, but the issues are still more extreme when trying to set clear rules that allow *ex ante* competition law compliance.

13. The key problem here is that it is not clear what the appropriate benchmark should be. One obvious option is the “competitive price”. But how does one define the competitive price in a market that is not competitive? Should dominant firms really be required to price at levels which would obtain under vigorous (Bertrand) price competition, when such prices would not be observed in non-cooperative oligopolies not subject to Article 82?

14. In *United Brands*, the Court of Justice used the alternative concept of “economic value”:

“charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied is [...] an abuse.”

15. But there are serious problems with this test too. In economic terms, if a person is willing to pay a given price for a product, then the economic value of that product to that person must be at least as high as that price. It is worth noting that the UK Court of Appeal recently overturned a High Court finding of excessive pricing, on the basis that the “economic value” of a product should take account of its value to the buyer. Since this latter concept equates economically to what a buyer would be willing to pay for the product, this line of reasoning taken to its logical conclusion would seem to suggest that – based on the “economic value” test – excessive pricing cases cannot be brought if the buyer ever actually buys the product.

16. One can, of course, look at historic margins, margins in other regions or countries for comparison or margins earned in similar industries. “But”, say the advocates of a *laissez-faire* approach to excessive pricing, “none of these is perfect and sometimes none is possible.” Moreover, even if one does observe differences in margins, should

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this necessarily imply abuse, or should some degree of differential margin be acceptable?

*Price regulation is highly distortive*

17. Fourthly, and perhaps most importantly, it is argued that fines for excessive pricing effectively equate to price regulation. Indeed, sometimes such regulation is explicit.

18. The concern here is that price regulation can distort competition, investment and R&D, to the detriment of consumer welfare. In particular, ongoing price regulation of a dominant firm can:

   (i) *Inhibit entry/expansion by competitors*: Potential competitors are less likely to enter or expand in the market if they find it hard to compete against the low prices of the regulated firm. This is especially likely to be a problem where a dominant firm has important incumbency advantages, since new entrants would typically seek to win market share in such circumstances by undercutting the incumbent’s high prices.

   (ii) *Distort incentives for efficiency*: Suppose a firm has higher profits than its competitors primarily because it is highly efficient, for example if it has adopted state-of-the-art production processes. If such a firm runs the risk of being penalized for having excessive profits, and having its productivity gains expropriated by being forced to lower its prices, this could potentially discourage firms from improving efficiency (and productivity) in the first place.

   (iii) *Distort investment incentives, including on innovation*: More generally, a dominant firm’s market position will often derive partly from its past investments. And in some cases, the firm will require the high prices associated with its dominant position to recoup these past investments. From an *ex ante* perspective, future recoupment also serves as the incentive for those investments. This incentives issue is likely to be especially important for R&D investments, which can be highly risky, costly, and slow to generate revenues. Intellectual property rights are specifically designed to provide innovating firms with a degree of market power, and so to stimulate upfront R&D investment through the “prize” of higher than normal future profits. Any reduction in future profits – or a greater risk of these profits being regulated – could clearly jeopardize such incentives.

   (iv) *Distort pricing incentives*: Depending on the specific design of the price regulation, there is a risk that regulation can facilitate anticompetitive pricing. For example, suppose a dominant firm is regulated on its average price over two markets, and it faces potential competition in one of those markets. It will have an incentive to cut price in the contestable market to make entry unprofitable,
and this predatory behaviour will be costless because it can be funded by raising price in the non-contestable market and preserving the average price at the regulated level.

19. In terms of these distortions, it seems likely that the “deterrent” effect of excessive pricing rules – whereby dominant firms in the economy endeavour to keep prices below their “best guess” as to what constitutes excessive pricing – has the potential to be substantially more problematic than the ex post regulation of those dominant firms whose pricing has explicitly been found to be exploitative.

20. In the absence of excessive pricing rules, firms set prices to maximize profits. If they are concerned that their profit-maximizing prices might be seen as exploitative under competition law, though, this could lead them to alter their pricing behaviour in all sorts of unpredictable and distortive ways. By contrast, where competition authorities engage in ex post regulation of infringing firms, any distortions can be taken into account on a case-by-case basis and can, to some extent, be avoided by careful intervention design.

21. The distortions associated with the “deterrent” effect of excessive pricing rules provide a good policy argument for minimizing this deterrent effect, in particular by steering clear of imposing fines for excessive pricing and of allowing private damages actions in respect of such behaviour, since each of these strengthens firms’ incentives to abide by competition law. By limiting available sanctions to the imposition of ex post penalties, such as future price regulation, firms are likely to be less concerned about breaching excessive pricing rules, and as such the associated distortions across the economy should be greatly reduced.5

22. Another concern highlighted above was the risk that price regulation might inhibit entry or expansion by competitors, and so prolong the dominant firm’s market position. This is potentially a serious issue. However, it is worth noting that it would be less likely to arise in practice if the policy approach were adopted of only intervening in markets where one does not expect the high prices to stimulate successful new entry within a reasonable period. Under this policy, price regulation should not occur where competitors are realistically willing and able to enter or expand through undercutting the dominant firm’s prices, and so become a real constraint on the dominant firm.

Summary of policy implications

23. In summary, one might reasonably conclude from the above arguments that a sensible policy approach towards excessive pricing would have the following characteristics:

5 Given the very limited numbers of excessive pricing cases we observe (even in Europe), one might anyway expect that there is not a substantial ex ante deterrent effect on pricing in practice. However a recent (and as yet unpublished) study by the OFT on the deterrence effect of the UK competition regime found a not insignificant amount of deterrence of pricing behaviour due to concerns it might be found to unlawfully exploit dominance (although it is also notable that the deterrence levels for excessive pricing were substantially lower than for any other form of abuse).
• There should be no intervention against high prices if one expects them to stimulate successful new entry within a reasonable period.

• In examining high prices for one element of a firm’s product portfolio, it is important also to consider carefully the pricing of other elements of its portfolio, the competition the firm faces in those other markets, and the impact on consumers’ choices.

• In order to reduce deterrence, firms should not face fines for excessive pricing, and should not face the risk of private damages actions in respect of such behaviour.

24. None of the above are currently explicitly (or even implicitly) incorporated within EC competition policy. Their adoption would therefore go a long way towards meeting the concerns set out above. Of the three, the third would probably be the most controversial.

25. However, vigorous advocates for a *laissez-faire* approach to excessive pricing would argue that the concerns set out above are so serious that it is wrong for competition law to proscribe high pricing at all. They would typically accept that there may need to be explicit regulation for certain areas of natural monopoly – such as the utilities – but they would argue that such regulation should be done carefully by specialist regulators. The rest of the economy should be left alone, not least because the risks of careless and ill-informed intervention outweigh any potential benefits.

**Arguments for a degree of intervention against excessive pricing**

26. Against this view, a number of arguments can be made as to why competition law *should* cover excessive pricing.

*Good fit with the objectives of competition policy*

27. Firstly, there is the simple philosophical point that there is a clear potential for consumer harm from excessive pricing. Indeed, it is arguable the primary rationale for competition policy is – in the end – to limit the potential for such exploitative behaviour, and in so doing to benefit consumers. As such, there is a good fit between a law against excessive pricing and the overarching objectives of competition policy.

28. This point is given further weight by a recent paper by Akman (2007)\(^6\) which reviews the *travaux préparatoires* (preparatory documents) associated with the initial drafting of

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Article 82 (then Article 86) in order to find out the “legislative intent” of the provision. Akman concludes that:

“…the provision was intended to apply to only ‘exploitative’ abuses and not ‘exclusionary’ abuses. Their main worry being ‘increasing the size of the pie’….”

Price regulation of this sort occurs elsewhere in competition and consumer law

29. Secondly, it is pointed out that certain forms of high pricing are already proscribed under other parts of competition and consumer law. For example:

(i) The law on exclusionary abuse of dominance can require dominant suppliers to ensure that their pricing is fair and reasonable: High prices charged by an upstream supplier to a downstream firm can constitute a constructive refusal to supply or margin squeeze if they restrict or distort the ability of the latter to compete on the relevant downstream market.

(ii) Fair and reasonable pricing may in some cases be necessary to justify the application of Article 81(3): This may be the case in particular with respect to the exemption of horizontal agreements. There may be two possible rationales for such requirements:

a) To ensure that the horizontal agreement does not eliminate competition. An example concerns standard-setting organizations, in respect of which the Commission’s Guidelines on Horizontal Cooperation Agreements specify that:

“To avoid elimination of competition in the relevant market(s), access to the standard must be possible for third parties on fair, reasonable and non-discriminatory terms.”

b) To ensure that the restriction to competition is no greater than is required to achieve the benefits. An example here is the UK LINK case (2000), in which the OFT concluded that an agreement between UK banks, relating to the cross-charge levied for the use of each others’ ATM machines, would

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7 Ibid. Akman also provides evidence that there was dispute during the early years of Article 82’s implementation as to whether it applied to only exploitative abuses or included exclusionary abuses as well. For example, Joliet (later a judge of the ECJ) was of the view that it merely covered exploitative abuses, the test of legality being not the interference with other firms’ freedom to compete and the use of “exclusionary” practices to achieve and hold power, but rather whether there is monopolistic exploitation of the market. See René Joliet, Monopolization and Abuse of Dominant Position, Martinus Nijhoff, 1970. Joliet apparently reached this conclusion by studying the examples listed in Article 82.


9 Office of Fair Trading, Case CP/0642/00 LINK Interchange Network Ltd (11 May 2000).
qualify for an exemption so long as the charge was set no higher than required for cost recovery.

(iii) The regulation of unfair contract terms requires that hidden charges be “fair”: Where consumers face additional charges that are not covered by the “core terms” of a standardized contract with a supplier, these may contravene consumer law if they are not “fair”. “Fair” in this situation has regularly been interpreted as “cost-reflective”. A recent example in the UK was the OFT’s threatened action against the default fees charged by credit card issuers for late payment of invoices, which were considered to be substantially above cost.  

30. In addition, in the UK, the Enterprise Act 2002 empowers the authorities to carry out market investigations where there are “features” of a market that prevent, restrict or distort competition. Such investigations regularly examine markets in which prices are found to be excessive, and one potential outcome is to impose price regulation remedies. However, in practice the UK Competition Commission has typically preferred remedies designed the make the markets involved work more effectively, which should in turn lead to lower prices, as opposed to regulating prices directly. This alternative approach to addressing excessive pricing is discussed further below.

Assessment difficulties are overstated

31. Thirdly, while it is true that assessment of excessive pricing can sometimes be difficult, it would be wrong to overstate these difficulties. On the one hand, they do mean that it can be difficult to set out guidance that draws a clear line between excessive pricing and lawful pricing. On the other, there will nevertheless be cases where the excessive pricing is sufficiently extreme that it is relatively easy to demonstrate, based on a variety of different measures.

32. An example is the OFT’s Napp case (2001), which related to the excessive pricing of a sustained release morphine product. This case was arguably not a typical excessive pricing case since there were two elements to the case: exclusionary low pricing to the hospital sector and excessive pricing to the “community sector” (i.e., the pharmacy sector). While the OFT chose to run the case as two separate abuses, this particular instance of excessive pricing could instead have been framed as ongoing recoupment from Napp’s predatory strategy, rather than as an abuse in its own right.

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10 See http://www.oft.gov.uk/news/press/2006/credit-cards. In the event, the credit card companies reduced their charges in order to avoid action, so the case did not go to court.
11 Market investigations are carried out by the UK Competition Commission, following a reference from the OFT or another designated body.

33. Nevertheless, the case demonstrates well how one can sometimes observe clear water between “excessive” pricing and “competitive” pricing. In assessing Napp’s pricing, the OFT benchmarked Napp in several different ways:

- **Price-cost margins** were compared both across Napp’s activities and with those of Napp’s competitors.

- **Prices** were compared not only across activities and with those of competitors, but also across countries and over time.

34. Napp’s prices and margins were found to be high – and by some margin – relative to all of these different comparators. On this basis, and without facing any serious difficulties in assessment, the OFT found that Napp had exploited its dominant position.

*Potential distortions from price regulation are overstated*

35. Fourthly, the policy approach set out at paragraph 23 above would go a long way towards addressing the potential distortions highlighted as arising from price regulation. In particular, the deterrence effect would be greatly reduced, as would the risk of price regulation inhibiting a realistic prospect of entry or expansion by competitors.

36. Of continuing concern, however, are the potential distortive effects of *ex post* price regulation on upfront investment. Especially important here is investment in R&D, since R&D can play a crucial role in improving consumer welfare over the long term, and intellectual property rights are specifically designed to generate a degree of apparently “excessive” profits in order to incentivise firms to engage in costly and risky R&D in the first place.

37. To some extent, these various concerns can be ameliorated if competition authorities bear in mind the risks of intervention. They should intervene only after careful consideration of the potential distortive impact of any proposed regulation, and only in a manner that ensures appropriate returns to sunk investments.

38. However, in the case of R&D, the importance of ensuring incentives for dynamic competition may mitigate in favour of a stronger policy approach: specifically, there should be no intervention against excessive prices for an innovative product within that product’s patent life. It is noteworthy that in the *Napp* case, the OFT argued that the patent period provides an opportunity for recoupment of *ex ante* investment. While not made explicit, the tenor of this discussion suggests that the OFT would not have brought the case had the drug still been within patent.\(^\text{13}\)

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\(^{13}\) Note that this argument assumes that the patent regime is well designed in terms of achieving the right balance between positive effects for dynamic efficiency and negative effects for competition, or at least that it is not for competition policy to try and correct any design failures of the patent regime. This assumption, however, is clearly controversial.
Price regulation is not the only remedy!

39. Finally (and one of the key messages of this paper), it is important to recognize that price regulation is not the only possible remedy to a finding of excessive pricing. In the following section, we discuss an alternative approach to addressing exploitative abuse, which aims to address the causes of high prices, rather than the symptoms, and as such is less likely to result in market distortions.

40. The approach is grounded in the “demand side” of the market, and thus arguably has more in common with consumer policy than with traditional competition policy, or even sectoral price regulation. As such, for some competition authorities it may tread relatively new ground and involve new thinking. However, the benefits are potentially large, not least in terms of limiting the extent of ongoing price regulation.

An alternative approach to remedying exploitative abuse

41. As a general rule, exploitative abuse over a prolonged period occurs only where there are barriers to entry or expansion, preventing competitors from undercutting the dominant firm and eroding its market position.

42. Sometimes these barriers relate purely to the supply side of the market. For example, potential competitors may lack access to crucial IP or they may face insurmountable regulatory barriers to entry.\(^{14}\)

43. Often, however, the most serious barriers to entry and expansion will be to some extent related to the demand side of the market: that is, related to the characteristics and behaviour of buyers. These include:

   (i) **High switching costs:** whereby buyers find it difficult or costly, or generally lack the incentive, to switch between suppliers.

   (ii) **Lack of shopping around by customers:** whereby buyers find it difficult or costly, or generally lack the incentive, to shop around between suppliers.

   (iii) **Lack of comparable information across suppliers:** such that buyers are unable to make rational decisions across suppliers.

   (iv) **Asymmetric information between firms and customers:** whereby buyers cannot observe all product characteristics (most usually, product quality) and therefore are overly reliant on supplier reputation or past experience with a given supplier.

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\(^{14}\) It should be noted that where competition problems arise due to regulatory barriers to entry, competition authorities have an important competition advocacy role to play in trying to reduce such barriers.
44. In such situations, the authorities may be able to put in place remedies which alleviate the relevant demand side problems and in doing so activate buyers to drive up the degree of competition in the market. This should in turn lead to lower prices and eliminate any need for price regulation. A non-exclusive list of possible interventions is provided in Box 1 below.

45. As mentioned above, in the UK, the Enterprise Act 2002 empowers the Competition Commission to carry out market investigations. These are specifically designed to take a holistic approach to looking at why markets are not working well, examining causes of problems as well as symptoms, and reviewing demand side issues of the type above alongside supply side issues. The Competition Commission also has a wide range of sanctions available, the main constraint being that its interventions must be proportionate to the problems it identifies in the market.

46. However, other Member States do not have such wide-ranging powers. The ability to bring excessive pricing cases under Article 82 would therefore seem to provide a useful and important avenue for other authorities to bring the sort of interventions listed in Box 1.\textsuperscript{15}

47. Such interventions – where effective – have the potential to generate far greater benefits for consumers than price regulation, since enhanced competition will typically be more effective at driving up quality, service and innovation and driving down costs. At the same time, they do not have the downsides of price regulation described above.

Conclusions

48. Having set out the arguments for and against a laissez-faire approach towards excessive pricing, this paper proposes that a sensible policy approach would have the following characteristics:

(i) There should be no intervention against high prices if one expects such prices to stimulate successful new entry within a reasonable period.

(ii) In examining high prices for one element of a firm’s product portfolio, it is important also to consider carefully the pricing of other elements of its portfolio, the competition the firm faces in those other markets, and the impact on consumers’ choices.

\textsuperscript{15} An alternative would clearly be for other jurisdictions to adopt a market investigation law similar to that in the UK, but this would clearly require far-reaching legislative change.
(iii) In order to reduce deterrence, firms should not face fines for excessive pricing, and should not face the risk of private damages actions in respect of such behaviour.

(iv) There should be no intervention under Article 82 against the high prices of an innovative product within its patent period.

(v) More generally, competition authorities should consider carefully the effect of any *ex post* intervention on *ex ante* investment incentives.

(vi) Competition authorities should seek alternative remedies to price regulation, which are designed to address demand side problems and thereby to activate competition in the market.

49. While these various changes to policy would not overcome all of the concerns raised by advocates of a *laissez-faire* approach to excessive pricing, they would go a long way towards doing so.

50. In the view of the authors, adoption of such an approach would tip the balance towards maintaining a policy of intervening against excessive prices under Article 82. One important factor in reaching this conclusion is that many jurisdictions do not have other levers to press in order to seek alternative demand side remedies designed to market markets work more effectively, of the sort set out in Box 1.
Box 1: Possible demand side interventions to enhance entry/expansion

1. Interventions to facilitate switching
   - Cancellation rights (improved, clearer, easier to apply)
   - Number (or similar) portability - where customers are attached to an element of their present product
   - Customer information portability - where new suppliers face information asymmetries/disadvantages relative to current suppliers
   - Improved ease/speed of switching

2. Interventions to facilitate shopping around
   - Cooling off periods (improved, clearer, easier to apply)
   - Written quotations, lasting for a fixed period
   - Search routines and price comparison websites
   - Consumer education and advocacy (about the benefits that shopping around could bring)

3. Interventions to facilitate comparisons between offerings
   - Clear upfront prices (for all elements of the package)
   - Standardised prices (e.g., APRs for credit products)
   - Standardised products (e.g., in insurance – base line cover)
   - Price comparison tables (e.g., as provided for loan products on the website of the UK Financial Services Authority)

4. Interventions to overcome asymmetric information problems
   - Warranties schemes
   - Complaints/redress schemes
   - Minimum quality standards
   - Licensing schemes
   - Legislation that encourages the use of independent advisors (as in financial services)
   - Codes of practice