

On exploitative excessive pricing under EC law

Paper prepared for a presentation by Pedro Fernandes at the Autoridade da Concorrência, Lisbon, 9 January 2006.

Introduction

¹ This paper sets out an approach that may be of assistance to an authority investigating, under Article 82, allegations of exploitative abuse through excessive prices by a firm with a dominant position.

² The paper, drawing on the relevant EC case law, puts forward an interpretation of exploitative abuse and discusses the type of evidence that the authority could examine in pursuing such a case.

³ We will not address other types of abuse such as price squeezing or predatory pricing. Rather, the focus will be on exploitative abuses. These abuses have no direct detrimental impact on competition but they can harm customers as higher prices are charged than would have been charged if no abuse were committed.

Hypothetical case: exploitative abuse on buses

⁴ We will illustrate the discussion throughout this paper by making use of a hypothetical case relating to a complaint of excessive fares on public buses. We will consider different scenarios in the paper to allow us to explore different aspects of exploitative abuse. All these scenarios share, however, the following background:

Basic facts of hypothetical case

Bus operator Rebus runs bus services in and around the town of Reckonville. There is no other bus company in that area and there is no other public transport. There are no special or sector specific regulations and, in particular, Rebus has the freedom to set prices and timetables. A complaint has been made by the local passenger association that Rebus' fares are excessive. The relevant competition authority investigating the complaint has already established that Rebus has a dominant position in the supply of public transport services in Reckonville. The relevant competition law is equivalent to Article 82.

Exclusionary abuse in one market may allow for exploitative abuse in another market

⁵ In addition to the basic facts of the case just given, consider the following scenario:

Scenario 1

In the course of the investigation, it was found that Rebus owned the only bus terminal in Reckonville and that, in the recent past, there had been a number of episodes in which Rebus had not granted access on reasonable terms to other bus operators interested in starting bus services in Reckonville.

Examining Rebus' behaviour in this regard, the competition authority concluded that Rebus' bus terminal in Reckonville is an essential facility and that its refusal to grant access on reasonable terms amounts to an abuse of its dominant position in the supply of facilities at bus terminal.

⁶ In light of the facts in Scenario 1, the complaint relating to excessive pricing could be structured as follows: Rebus has abused its dominant position in the supply of terminal facilities by not giving access on reasonable terms to interested parties and, by thus preventing rival bus companies from running services, it has been able to charge excessive prices.

⁷ Framed in this way, the case against Rebus shares key elements with established EC case law on exploitative abuse, and it is helpful to examine this to understand how the case on Rebus' excessive prices could be constructed. In this regard, we think it is particularly useful to examine the 2002 decision of the UK Competition Appeal Tribunal (CAT) in Napp, where the relevant competition law is analogous to Article 82. This case was considered by the CAT following an appeal by Napp, a pharmaceutical manufacturer, against a decision by the Director General of Fair Trading.

⁸ The case relates to the sales of Napp's sustained release morphine drug, MST, to the "hospital sector" and to the "community sector" i.e. to patients under the care of their General Practitioner. The two sectors were considered to be distinct markets, although a link exists between the two in that, because of referrals and reputation effects, sales in the community sector were largely driven by the availability of the drug in the hospital sector. Napp was found to have a dominant position in the relevant markets in both sectors.

⁹ The case considered by the CAT is a complex one and we limit ourselves here to setting out the points of greatest relevance to the topic of this paper. Napp, was found to have adopted a commercial policy in relation to MST which excluded competition in the "hospital sector" (namely by predatory pricing). This practice in the "hospital sector" was found to have effectively denied rivals access to the "community sector" by virtue of the fact that sales in this sector were driven largely by availability in the hospital sector. The CAT found that this conduct infringed Chapter II of the UK Competition Act 1998, whose provisions are analogous to those of Article 82.

¹⁰ In addition, Napp's prices of MST in the "community sector" were found to be excessive: Napp was found to have engaged in an exploitative excessive pricing abuse.

The CAT reaches the following view (paragraphs 400–402):

“It is therefore established, on the facts of this case, that during the period of infringement Napp charged significantly higher prices in the community segment than in other markets or segments where it faced competition, and has significantly higher margins in the community segment than its most profitable competitor. In addition, Napp faced no competitive pressure on its prices in the community segment, had no patent protection, and enjoyed a market share of 96 per cent throughout.

[..]

We are satisfied that Napp “has made use of the opportunities arising out of its dominant position in such a way as to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition”, so as to satisfy the test of abuse as laid down by the Court of Justice in *United Brands* at paragraph 249 of its judgment.”

¹¹ The CAT reached the view that Napp had made use of its dominant position and of the fact that the conditions in the market were not those of “normal and sufficiently competitive competition” to impose terms of trade that were less favourable to trading counterparties than would be expected to prevail in conditions of “normal and sufficiently effective competition”.

¹² Our interpretation is that the “normal competition” counterfactual is defined as a world where, all else being equal, the effect on competition resulting from the anti-competitive abuse in the “hospital sector” would not have been felt.

¹³ On the basis of this interpretation, the assessment of whether Napp’s prices in the “community sector” were excessive or not can be determined by comparing the actual prices with those that would have been set in a counterfactual in which the effects on competition from Napp’s anti-competitive abuse in the “hospital sector” were assumed away.

¹⁴ We would suggest that Reckonville’s competition authority can, in making its initial step to determine whether Rebus’ fares are excessive, take guidance from the reasoning followed by the CAT. In this light, the relevant line of inquiry would be to answer the following question: are Rebus’ current prices greater than those that Rebus would have set if the exclusionary effects of its policy on granting access to its depot were assumed away? We leave for later the discussion of what analysis can be carried out to help answer this question and instead emphasize the following point: determining whether actual prices are excessive requires a comparison of these prices with those that would be expected in a counterfactual of normal competition. In this case the relevant normal competition counterfactual is one where the abnormal restrictions on competition relating to the exclusionary effects of Rebus’ conduct were absent.

Use of State powers to restrict competition may give opportunity to exploitative abuse

¹⁵ Instead of the setting described in Scenario 1, consider the following:¹

Scenario 2

In the course of investigating the complaint about Rebus’ alleged excessive prices, it was found that Rebus had been granted the exclusive concession to run local public transport by Reckonville town hall by a corrupt Reckonville town hall official.

¹⁶ In the light of the facts presented in Scenario 2, the investigation into Rebus’ excessive prices could run as follows: Rebus has been able to charge allegedly excessive prices because it holds the exclusive concession to run bus services in Reckonville and this concession was granted on corrupt grounds.

¹⁷ We have constructed this scenario because, besides the exclusionary restrictions on competition, considered above, EC case law points out that, in some circumstances, restrictions on competition imposed by the State may be deemed to be abnormal restrictions and relevant to an investigation on exploitative abuse.

¹⁸ The most relevant case here concerns a reference to the European Court of Justice (ECJ) for a preliminary ruling by a French court, hearing a dispute between *Pompes Funèbres des Régions Libérées (PFRL)* and *Mrs Corinne Bodson*.

¹⁹ PFRL had been given an exclusive concession by the town of Charleville-Mézières to provide the “external services” for funerals (e.g. carriage of body after it has been placed in coffin, the provision of hearses and conveyances for mourners). Then, around 5,000 of the 36,000 French communes grant an exclusive concession to a private undertaking to provide “external services” for funerals. Mrs Bodson had organised funerals within the territory of the town of Charleville-Mézières. PFRL, as the holder of the exclusive concession, instituted proceedings against Mrs Bodson and obtained an interim injunction from the court prohibiting her from engaging in activities relating to “external services” for funerals. Mrs Bodson appealed to the Court of Cassation against that judgment, claiming that PFRL had abused its dominant position on the market. That court, in turn, referred four questions to the Court on a number of matters including abuse of a dominant position.

²⁰ On the issue of abuse, Mrs Bodson had contended that PFRL and its subsidiaries charged excessive prices, whilst PFRL and the French Government denied the prices were unfair.

²¹ In its assessment of PFRL’s dominant position, the opinion of the ECJ notes that “the application of Article [82] is not precluded from the fact that the absence or restriction on competition is facilitated by laws or

¹ Please note that in the slides accompanying the seminar at the Autoridade, Scenarios 2 and 3 were presented in reverse order.

regulations”, namely the decision by the commune to grant an exclusive concession. In its analysis of the alleged abuse, the ECJ indicates that the price imposed by the concession holder could constitute an exploitative abuse of a dominant position.

²² The source of the abnormal restrictions on competition in *Bodson* seems clear: the decision by the local authority to grant an exclusive concession rather than operating a policy that would not create a local monopoly in the relevant funeral service market(s).

²³ *Bodson* indicates that the normal competition counterfactual used to identify the exploitative abuse of a dominant position can, in the appropriate setting, be defined as a hypothetical world that differs from the real world in that certain restrictions on competition that result from the use of State power to grant exclusive concessions are absent. This view is supported by the ECJ’s identification of the opportunity for the alleged infringement to be investigated through a comparison of prices in territories where an exclusive concession is granted with those elsewhere.

²⁴ Accordingly, in Scenario 2, the investigation into Rebus’ prices would be conducted with a view to establishing whether actual prices differ from those that would have been charged if the effect of the abnormal restriction on competition — the corrupt use of State powers to award an exclusive franchise — were absent. To construct this counterfactual it would be necessary to ascertain how, in the absence of making a corrupt decision, bus services would have been organised in Reckonville: it might be the case that an exclusive concession would have been granted on some reasonable basis (e.g. to the operator offering the best quality of service or raising most revenue to the town hall) or that no exclusive concession would have been granted at all. To settle on which of these, or other, scenario best describes the counterfactual of normal competition it would be necessary to gain an understanding of Reckonville’s town hall policy on buses. In turn, and as we discuss further below, what the relevant normal competition counterfactual looks like will determine the type of analysis that is relevant to investigate Rebus’ price levels.

²⁵ Our understanding is that it is not the case that every decision by the State, for which an alternative decision would have had a less restrictive impact on competition, should be identified as an abnormal restriction on competition: a distinction exists between permissible and abnormal State restrictions on competition. The main reason to believe this is that it would verge on the impossible for any dominant undertaking to comply with competition law if it had to assess all possible removals of State restrictions on competition and set its price at the lowest level arising under all these counterfactuals.

²⁶ In this light consider, in alternative to Scenario 2, the following:

Scenario 3

In the course of investigating the complaint about Rebus’ alleged excessive prices, it was found that Rebus had been granted the exclusive concession to run local public transport by Reckonville town hall on the basis of an open competition in which the award was to be granted to the highest bid, subject to some minimum service standards. Reckonville town hall had chosen to grant an exclusive concession on the basis that it thought this would be the arrangement that would generate the most revenue to its coffers.

²⁷ Contrary to the practice of granting a concession on the grounds of friendship or political favour, it is, arguably, a reasonable objective for Reckonville’s town hall to aim to structure its bus concession policy on the basis of generating the most revenue and, therefore, for it to award, as in Scenario 3, an exclusive concession to the highest bid. In this scenario we would not be able to identify any abnormal restrictions. The restriction on competition here — the fact that the concession is granted on an exclusive basis — could be regarded as being tied to, and proportional with, the objective of eliciting the most revenue possible. Rebus, or any other potential bus operator, would not be willing to offer as high a bid were it not certain of being granted exclusivity.

²⁸ Accordingly, we would not regard the restriction on competition that comes about from the fact that an exclusive concession is granted as one that is abnormal. Putting it differently, we think that it would not be possible to construct a counterfactual of normal competition where the town hall’s legitimate objective is also being met, that is different from the real world. It follows that, under Scenario 3, a complaint about Rebus’ excessive prices would not be able to proceed.

Exploitative excessive pricing

²⁹ More generally, exploitative excessive pricing can be summarised as follows.

³⁰ Forms of exploitation of a dominant position which are prohibited as abusive can be characterised as exploitation of restrictions on competition that are not compatible with normal conditions of competition, which we term “abnormal restrictions on competition”. In particular, restrictions on competition that are unlawful, together with restrictions on competition that are imposed by the State and are disproportionate to the legitimate objectives of the State, are not compatible with normal conditions of competition. Any undertaking with a dominant position is prohibited from exploiting such abnormal restrictions, whether or not it bears any responsibility for their existence.

³¹ We have found workable an approach whereby an exploitative excessive price is defined by reference to a counterfactual of normal competition, more precisely a counterfactual that is defined by the absence of abnormal

restrictions on competition that can be considered incompatible with normal conditions of competition.

³² Under this approach, proving abusive exploitative excessive pricing requires evidence of the following:

- (a) that the undertaking holds a dominant position in the relevant market;
- (b) that there are restrictions on competition in the relevant market that are not compatible with normal conditions of competition; and
- (c) that prices and/or other terms of trade would be more favourable to the dominant undertaking's trading counterparties if these abnormal restrictions were not present (everything else equal).

What analysis is relevant to determine whether prices are excessive

³³ In order to show the last leg of our interpretation of excessive pricing, the investigating authority may find itself surrounded by data on prices, costs and profits. But which of these data, and what analyses, are relevant to determine whether prices are excessive under Article 82? There is a danger of jumping into a series of price comparisons and cost analyses without a clear conceptual basis for the assessment.

³⁴ Other commentators have noted that the ECJ has developed a “veritable cocktail of approaches” to assess allegedly exploitative excessive prices.² We find that the line of inquiry we have set out above provides helpful guidance amidst such a cocktail. In particular, it suggests that the choice of what data analysis to carry out must be made on the basis of that which can best estimate what the relevant price would be in conditions of normal competition. Crucially, the relevant evidence is therefore guided by the relevant concept of normal competition and not by data availability.

³⁵ We turn to review the appropriateness of using evidence on prices, costs and profits, referring to the hypothetical example of the bus operator Rebus where appropriate.

Price analysis

³⁶ As set out earlier, the analysis of whether prices are excessive or not should rest on the comparison of actual prices with those that would have been set in the counterfactual of normal competition. In the case of the hypothetical example under Scenario 1, the normal competition counterfactual refers to a world where the exclusionary effects of Rebus' refusal to grant access to its Reckonville terminal are not felt and where there is competition from other operators, or from the threat of their entry. It may be possible to identify similar routes in other towns similar to Reckonville other than for the fact that Rebus faces actual or potential competition from

other bus operators (e.g. because there are no issues about accessing a terminal). If this is the case, then the bus prices in these comparator routes in these other comparator towns would be informative of the prices that would have been set by Rebus in Reckonville had conditions of competition there been normal and, therefore, informative of whether actual prices are excessive.

³⁷ This type of analysis was put forward by the ECJ in *Bodson*: the Court considered that a comparison between the prices charged by the undertakings which hold concessions with prices charged elsewhere should be feasible and that, in this case, this would provide a basis to assess whether the prices charged by concession holders are fair.

³⁸ The difficulty with this approach lies in finding appropriate comparators. It will be unlikely for there to be a network of bus routes in other towns that differ from Reckonville only by virtue of the abnormal restrictions being absent. In all likelihood, there will be a considerable number of dimensions along which there will be differences including the length of routes and size of bus network, quality of service the size of the passenger population, the existence of competing public transportation such as trains, differences in local income.

³⁹ It might be possible in some cases to correct for this by stripping out the effects of differences between comparators that cannot be considered to represent abnormal restrictions on competition in the market under investigation. Econometric analysis would be one tool to use for such an exercise and, in such an exercise, a clear definition of the normal competition counterfactual gives guidance on what variables should and should not be controlled for. However, the competition authority should be aware that the level of uncertainty introduced in the analysis by a series of adjustments for differences between comparators may mean that evidence obtained by such a process is insufficient to prove an infringement.

Cost analysis

⁴⁰ The usefulness of cost analysis is likely to depend on the form of competition that is deemed to prevail in the normal competition counterfactual. If the normal conditions of competition come close to a textbook theory of perfect competition, or at least lead to prices that are constrained by the threat of entry of suppliers into the relevant market, then the analysis of the costs of a new entrant is likely to provide good evidence about the level of prices in the counterfactual. On the other hand, if entry is not an effective constraint even in the normal competition counterfactual then the same type of analysis would not be useful, and the focus may instead shift towards price comparisons with similar markets in which competitive conditions are close to the relevant normal competition counterfactual.

⁴¹ In the case of the Rebus example in Scenario 1, the entrant could well be a bus operator that is active in an adjacent market and that has some of the relevant

² See Motta, Massimo and Alexandre de Stree (2003). “Exploitative and exclusionary excessive prices in EU Law”, presented at the 8th Annual European Union Competition Workshop, Florence, page 3.

capabilities to supply the market in question but which is currently prevented from doing so due to the effects of Rebus' abnormal restrictions on competition. A bottom-up cost model can be constructed to establish the minimum price that the entrant would need to expect to set in order for the entry decision to be attractive. This, in turn, can be used to provide evidence as to whether Rebus has set prices higher in Reckonville than it would have set had such a competitive constraint existed.

⁴² Had we been considering a very simple technology, rather than buses, a straightforward case would be one where the normal competition counterfactual would involve the dominant firm setting prices that are constrained by the threat of entry by single-product firms with no fixed costs. In this simple case, the analysis required to establish that prices are higher than would be set in the counterfactual would involve a model of the variable costs that would need to be recovered through the price of that product. In the more complex case of the Rebus example, where there are fixed costs, more complicated models are required as the entrant would need to recover the fixed investment costs over the expected life of the entry decision. These models would also need to incorporate evidence on the cost of capital for such an investment in entry.

⁴³ The reliance on cost analysis would be further complicated if it is thought that the relevant counterfactual of normal competition would be characterised by Rebus facing effective competitive constraints from firms using multi-product technologies. To see this imagine that there are three areas in Reckonville linked by Rebus, areas A, B and C, and that Rebus currently runs the routes A-B, A-C and A-B-C. Further, it is thought that in the counterfactual of normal competition the fares on these services would be constrained by the (threat of) entry of a bus operator that could run different permutations of routes linking the three points of interest; entry might be from an operator that would run A-B alone, or from an entrant that would run A-B-C, A-C or from one that would run C-A-B and A-B, say. In this setting, cost analysis would involve first estimating the costs of running each of these routes and then solving a multi-variate problem for the prices of each of the products; the equations of the problem are given by the constraint that no potential entrant/technology must be able to earn positive economic profits at sustainable prices. The prices thus derived would reflect the prices expected to be observed in conditions of normal competition and these could then be compared with the observed Rebus prices to inform on whether the latter are excessive or not.

⁴⁴ Whenever cost analysis of the kind set out above is used, the following principles apply:

- (a) The relevant concept is one of forward-looking avoidable cost: what matters to the estimation of the prices that would attract new entrants are the costs that a hypothetical new entrant would avoid by not entering.

- (b) The most efficient kind of hypothetical new entrant is assumed. For example if there are significant economies of scope between the services under consideration and a particular type of existing business, then the new entrant should be modelled as being one of these existing businesses (an entrant that does not exploit such opportunities for efficiency gains would be expected to lose out to one that does, so it is the latter's whose cost should be modelled). Similarly if there are economies of scale and if the removal of abnormal restrictions on competition would permit potential entry on an equally efficient scale as that of the incumbent then such a scale should be assumed.

- (c) The time period over which costs are estimated should be the life of the relevant hypothetical investment project: in a nutshell, a "whole-life forward-looking cost" concept is required.

- (d) The cost of capital should reflect the avoidable cost to the new entrant of raising the necessary capital and bearing the relevant risk, i.e. the level of expected profit necessary to attract capital from market investors. This can usually be estimated by reference to the returns or expected returns observed on investments with similar risk profiles, and/or by using models of expected returns such as CAPM.

⁴⁵ Finally, a further step might be required before it can be established that prices higher than the normal competition counterfactual have been imposed. If the hypothetical new entrant would be expected to supply services with different characteristics to the dominant undertaking, such that although effective competition would exist between these services there would be a price differential, evidence on the likely direction and magnitude of this premium is required before evidence on the price that the new entrant would have charged can be used to inform on the price that the dominant undertaking would have charged. Moreover, since there is feedback between that relative price difference and the volumes that the entrant would expect to supply of each of its services, these relationships might need to be captured in the model which attempts to predict a likely entry strategy.

⁴⁶ In estimating a hypothetical entrant's costs, evidence about the costs of similar activities currently undertaken by the incumbent may on occasions be useful. For example, Rebus' operating expenditure in Reckonville may be a legitimate proxy for an entrant's expenditure, insofar as it would expect to use a similar form of operation. It would, however, be appropriate to adjust Rebus' costs to take into account efficiency if there is evidence that the abnormal restrictions on competition that are assumed not to exist in the counterfactual lead to less effective competitive pressures on the relevant cost elements i.e. if there is evidence that Rebus is inefficient.

Profit analysis

⁴⁷In some cases it is possible that analysis of the profitability of the incumbent business provides relevant evidence on whether its prices are higher than they would be in the normal competition counterfactual.

⁴⁸The use of profitability analysis can be justified where, in the normal competition counterfactual, the incumbent would be expected to face competitive constraints from potential entrants that have very similar capabilities as the incumbent business (i.e. use the same production processes and inputs) and where both the incumbent business and these hypothetical entrants can be modelled as single-product firms. If these two conditions are met, an analysis of the profitability of the incumbent business (e.g. that measures returns in excess of the cost of capital for the entrant) can provide evidence as to whether a profitable opportunity for entry for these firms would exist in the counterfactual; that such an opportunity exists, in turn, provides evidence that the actual prices of the incumbent business are higher than it would impose in the normal competition counterfactual — i.e. evidence of exploitative abuse.

⁴⁹In the case of a multi-product firm (including one engaging in product differentiation or price discrimination), the use of profitability analysis is impeded because evidence of excessive profits cannot be mapped to the price of a single product. If Rebus operates in a number of different towns or, perhaps even if it just operates in Reckonville but runs different routes, it is not possible to infer from its overall profitability anything on the excessiveness of its price on a particular route. If the “same capabilities” condition is nonetheless satisfied, evidence of an excessive level of profit overall must indicate excessive prices for at least for some of the routes. However the test does not work in reverse: a lack of excess profits proves nothing because excessive prices might be missed if they are hidden in profit results by lower prices for other prices provided by Rebus’ business.

⁵⁰The use of profitability analysis might also miss excessive pricing if the incumbent production process reflects some inefficiency that would not be expected to be experienced by new entrants. In such a case, excessive prices might exist even if no excessive profit is found. This caveat is simply a clarification of the requirement that the relevant entrants to have the same capabilities as the incumbent business in order for profitability analysis to be justified. More generally, if that condition is failed the use of profitability analysis to inform on the question of whether an abusive price has been set is likely to be misleading.

⁵¹These shortcomings of profitability analysis, which apply for multi-product firms, and in cases where the

normal competition counterfactual involves competition between firms that use different production processes and inputs, is sometimes referred to as a “problem of joint costs”. But it should be recognised that this “problem” is simply an inherent limitation of a profitability approach, and has no counterpart in the bottom-up avoidable cost analysis outlined above.

Exploitative abuse under EC law: key points

⁵²We find that exploitative abuse arises from the use of a dominant position to exploit restrictions on competition that are not compatible with normal conditions of competition.

⁵³We have put forward two types of restrictions on competition that could be considered to be abnormal on competition: restrictions caused by anti-competitive abuse (as in Napp) and restrictions due to disproportionate use of State power (as in Bodson). Other kind of abnormal restrictions may exist.

⁵⁴Holding a position of dominance does not imply that there exists an abnormal restriction. The price charged by a firm in a dominant position cannot be found to be excessive on the grounds of dominance alone; besides dominance, it would be necessary to identify the existence of a restriction on competition that is not compatible with normal competition. But it is necessary to go beyond this as finding that there is an abnormal restriction on competition does not mean that this has been exploited by the firm with a dominant position.

⁵⁵If an authority is satisfied that the firm in question holds a dominant position and that it has used this to exploit an abnormal restriction on competition, then its investigation should proceed to answer the question of whether the observed price is higher than it would have been in the absence of the relevant abnormal restrictions on competition.

⁵⁶To assess what the price would have been in such a counterfactual it may be appropriate to turn to price, cost or profit analyses depending on what the relevant conditions of normal competition are thought to be.

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