

Excessive pricing as an abuse of dominance – an economic perspective

Yossi Spiegel

Tel Aviv University and NYU Stern

Bergen, June 5, 2019

General considerations

The legal background

- Article 102 of the TFEU prohibits
 - “directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; ...”

- The GM case of 1975:
 - “the imposition of a **price which is excessive** in relation to the **economic value** of the service provided could amount to an abuse of dominance”

- The United Brands case 1978:
 - Is the “difference between the **costs actually incurred** and the **price actually charged** is excessive”
 - “if the answer to this question is on the affirmative, whether a price has been imposed which is either **unfair in itself** or when **compared to competing products**”

- Is this a two-step procedure?
 - Defendants: YES!
 - Motta and de Streel (2007): both parts are aimed to prove that a price is supracompetitive
 - Gilo (2018): “excessive prices are always unfair”
 - Is SLC a two step procedure?

Tests for excessive prices

- To determine that a price is excessive/unfair we need to establish the counterfactual price: the price “but for the abuse”

- Benchmarks:
 - Marginal/average cost (under perfect competition, $p = MC$ and in the long run, $p = AC$)
 - The price of the same product in the past (following a price increase) or the future (following a price cut)
 - The price of the same product in another market (geographical or other customers)
 - The price of competing products

Difficulties with cost tests

- Cost is hard to measure
 - How do we compute marginal cost?
 - Computing average cost is easier but how do you allocate common costs?
 - How do you factor in risk?
 - How do you factor the cost of capital?
 - In regulated industries, determining cost takes months and done in an interactive procedure

- Perfect competition does not always exist
 - In the presence of moral hazard price must be above cost (quality premium)
 - Vertical differentiation

Difficulties with price comparisons

- ❑ Comparisons are valid only if “all else is equal” (but for the abuse of dominance)
- ❑ Comparisons over time require a control group (a diff-in-diff exercise)
- ❑ Comparisons across markets need to ensure that costs are the same
- ❑ Comparisons with competing products are dangerous:
 - Other products are not dominant – why? Are they truly the same?
 - Research shows that firms in the same industry may have radically different costs

Comparison with competing products

- Two packages of a drug: A is sold at 100, B is sold at 50; is the price of A excessive?
 - Not if A has 80 pills and B has only 40 (same price per pill)
 - Not if A has double dosage (same price per 1 mg of active ingredient)
 - Not if A is twice as effective (same price per day of treatment)
 - Not if A has fewer side effects

- What if product A gives consumers a higher surplus despite having a higher price?

Excessive price cases are hard

- ❑ How high a price should be relative to a benchmark to be deemed “excessive”?
- ❑ What’s “unfair”?
- ❑ A ban on excessive pricing may have a chilling effect on investment (indeed this is why we have patents and copyrights...)
- ❑ How should firms know if it’s OK to raise prices?

Gilo and Spiegel (IJIO, 2018)

- Using a price cut following entry to establish that past prices were excessive has the following effects:
 - Restrains the dominant firm ex ante (in case it has to lower prices later following entry), especially when entry is highly likely
 - Discourages the dominant firm ex post from lowering prices (this may expose past prices as excessive)
 - Encourages entry because the dominant firm cannot lower prices by much in response to entry

- Similar effects when comparing the dominant firm's prices across markets

- In a broad range of cases consumers benefit from a ban on excessive prices (but not always)

Economic value

- The GM case of 1975 states that price should be compared to “the economic value of the service provided”
- What’s the economic value and to whom (there are many consumers with various degrees of WTP)?
- Aspen: economic value = price
 - But if economic value = actual price, the economic value can never be above the price \Rightarrow firms can never be convicted
- David Gilo: economic value = competitive price
 - But how do we know what the competitive price is?
 - What if a competitive equilibrium does not exist (due say to moral hazard or vertical differentiation)?
- How about comparing consumer surplus to producer surplus? (not easy to do but we understand the concepts)

Arguments for a ban on excessive prices

- Antitrust is about protecting competition – if you try to prevent monopolization and cartels, why accept a monopoly outcome when you have a dominant firm?

- But does competition mean
 - “the process” (the US approach)
 - “the outcome” (the EU approach)

- An example: a national coffee chain acquires a local coffee shop and raises prices according to its national price policy – is there a competitive problem?

- Intervene only if you protect the outcome
 - Why not always intervene when firms are dominant?

Arguments against a ban on excessive prices

- High prices are “self correcting” – entry will bring prices down

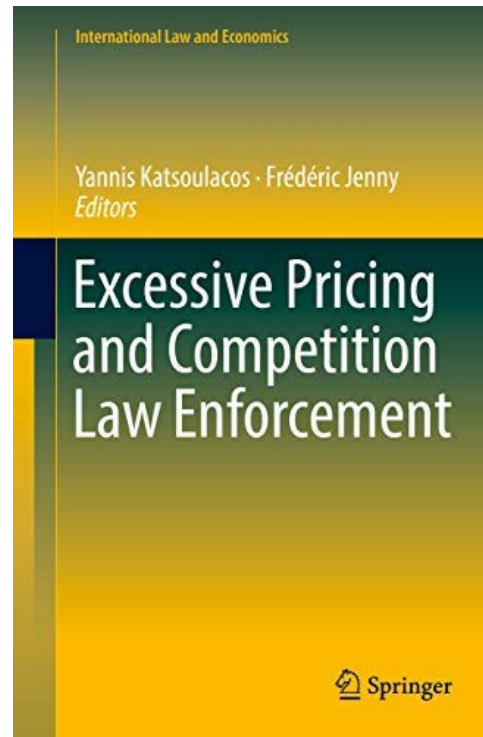
- If a dominant firm charges high prices, regulate it!
 - Ex ante and forward looking regulation creates certainty
 - Regulators have the expertise to set price while antitrust agencies and courts do not typically know how to set prices and cannot continue to follow the price over time and update it when needed
 - Regulation involves a bargaining process while antitrust enforcement is adversary

- A ban on high prices has a chilling effect on investment

- An adversarial process is inappropriate to determine the right level of prices and courts lack the expertise to do it
 - The Israeli experience shows that this is a serious argument

Populism: the Israeli experience

- A summary of the Israeli experience, as well as that of other countries, appears in “Excessive Pricing and Competition Law Enforcement,” Katsoulacos and Jenny (Eds.), 2018



Populism: the Israeli experience

- Since the 1990's private plaintiffs can file class actions on antitrust grounds
- Early attempts were not successful – very high bar for certification
- 2011: The cottage cheese boycott and the subsequent class action
- 2014: the IAA's publishes Guidelines 1/14: *"Preventing harm to consumers and the inefficiency in the allocation of resources as a result of excessive pricing is at the heart of the antitrust laws."*
- We now have close to 30 pending class actions:
 - Dairy products, margarine, soft drinks, frozen vegetables, instant coffee, green tea, Israeli cuscus
 - Natural gas, fertilizers
 - Burial services, postal services, phone calls, flights
- The Coca-Cola decision in late 2018 (appealed to the supreme court) lowered the bar significantly: if the dominant firm does not provide cost data in the certification stage, showing that there are cheaper products in the market is sufficient to certify the class action (and then the firm needs to supply cost data in the second stage...)

How do we move forward?

When are prices excessive?

- We still know little about the consequences of intervention, and there's a large grey area so it's better to move cautiously and go after clear cases
- Judge Potter Stewart: "I shall not today attempt further to define the kinds of material I understand to be ... ["hard-core pornography"], and perhaps I could never succeed in intelligibly doing so. But *I know it when I see it*"
- Finkel (2001): Defining what's fair is tricky but "Most often there is agreement over unfairness, and most cases are not hard cases" (albeit there are outliers)
- Kahneman, Knetsch, and Thaler (AER, 1986):
 - 82% of subjects think its unfair to raise the price of shovels after a snow storm
 - 91% think its unfair to raise rent after learning that the renter got a job near the apt. and is less likely to leave

Three cases

- Aspen: an obvious case
- Tnuva: no doubt that Tnuva exercised market power; is this an “abuse”?
- Coca Cola: shows the danger of adopting a populist approach to antitrust

The Aspen case

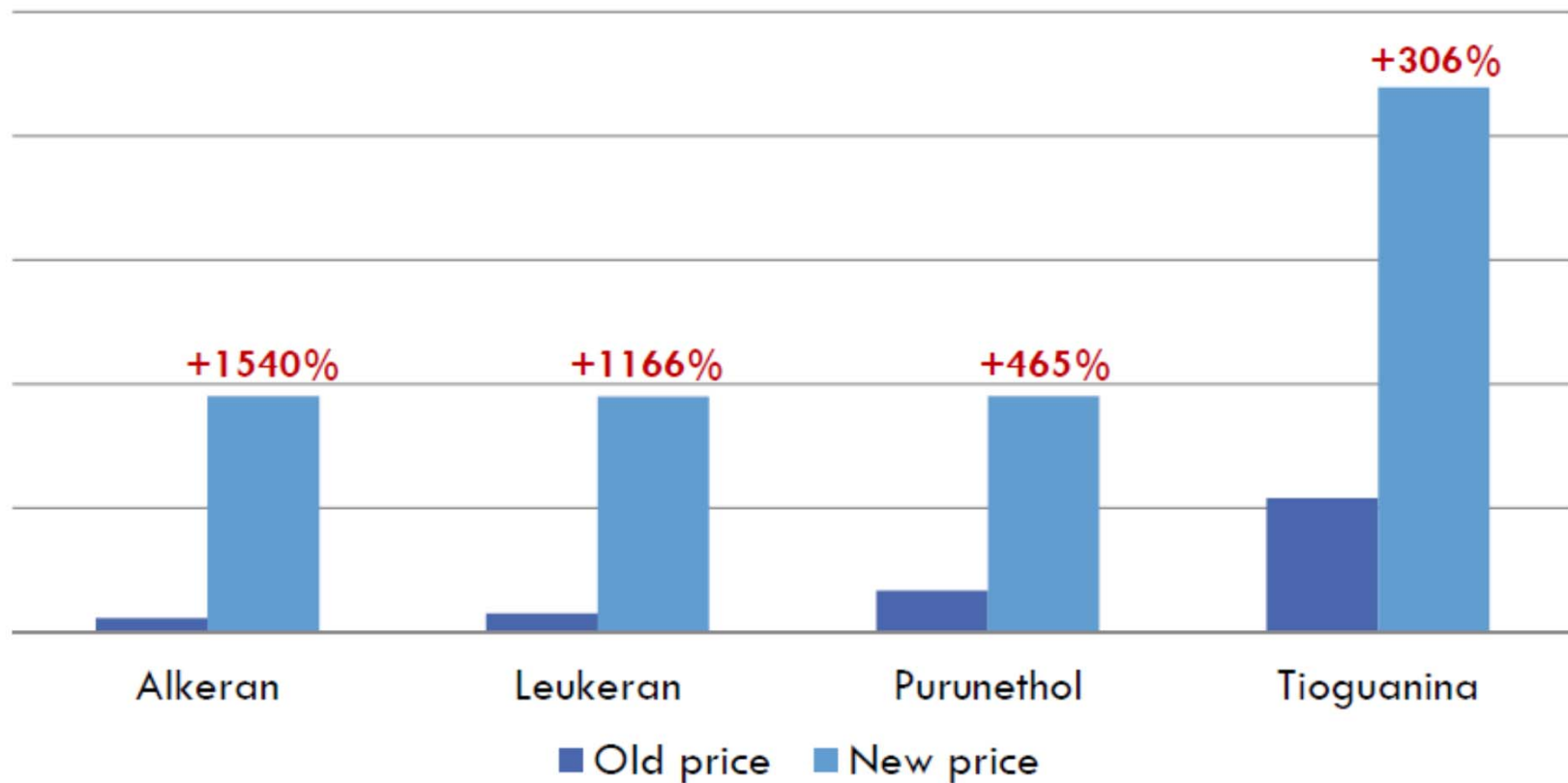
Aspen - background

- Aspen, a South African generic drugs distributor, bought from GSK in 2009 the right to distribute a portfolio of 4 blood anticancer drugs
- The drugs are sold since the '50s-'60s
- Aspen is a “middleman”
 - The drugs are produced by a German company
 - The drugs are distributed in Italy by LFM
- Under GSK, the sales of the drugs were 5M-10M Euros, and were classified as “A class” (the price is approved by a regulator, AIFA, and fully reimbursed by the NHS)

Aspen – the events

- ❑ April 2013: Aspen requests AIFA to move the drugs to “C class” (the price is deregulated and not reimbursed by the NHS) “[...] *in order to obtain the alignment of the sales prices ... with the prices applied in the other EU countries which ... are higher.*”
- ❑ AIFA rejected the request, as it “*was a totally exceptional circumstance: in fact, it is the first case ever occurred for anticancer drugs, given their life-saving nature and irreplaceability...*” and “*undoubtedly represented an aggressive behaviour in the company’s negotiation with AIFA.*”
- ❑ In October 2013, AIFA asked Aspen to submit a price proposal
- ❑ Aspen threatened to suspend supply in Italy; in early 2014, during the price negotiations, there was a supply shortage (supplies were redirected to Spain); Aspen claimed the shortage was due to LFM
- ❑ In March 2014, AIFA approved the new prices
- ❑ In October 2016, the ICA fined Aspen 5M Euro
- ❑ An appeal to the higher administrative court is pending

Aspen – the new prices



Important facts

- ❑ GSK did not lose money, so the price was above cost even before the increase (no need to measure cost)
- ❑ The price increase is 300%-1,500% (*"I know it when I see it"* plus nobody will argue that this is not substantial)
- ❑ No chilling effect: Aspen did not develop the drugs, does not produce them, and does not distribute them
- ❑ Entry is unlikely to a niche market so the problem is not "self correcting"
- ❑ The relevant consumers are cancer patients who need protection badly; their benefit clearly outweighs any cost due to type 1 errors (falsely rejecting requests to increase prices)

Aspen's defense

- Aspen appears dominant only because prices are so low that consumers never bothered to look for substitutes (a “reverse cellophane fallacy”)
 - But the huge price increase indicates that Aspen did not believe that there are good substitutes
 - The “silent majority fallacy”: what about patients for whom there are no good substitutes? A ban on excessive pricing is precisely meant to help those who cannot help themselves by switching

- The price was not raised for many years
 - But GSK did not lose money, so why raise the price?
 - Anyway what “justifies” a price increase other than “an exercise of market power” (which the law intends to prevent)

Aspen's defense

- The price is much higher in other European countries
 - In 2017, the EC has opened a formal investigation into information that Aspen has “imposed very significant and unjustified price increases of up to several hundred percent” in several member states
 - *“The Commission has information that, for example, to impose such price increases, Aspen has threatened to withdraw the medicines in question in some Member States and has actually done so in certain cases.”*

- The price was negotiated with AIFA
 - But did AIFA had a choice given Aspen's threat to suspend supply?

- The real consumer here is the NHS, which is a monopsony
 - The ICA does not believe the NHS has power vis-à-vis Aspen because if they exit the patients are in a bad shape
 - The whole thing is a bit cynical given that exit may be a death sentence to some patients (this is not your DWL harm; its real death)

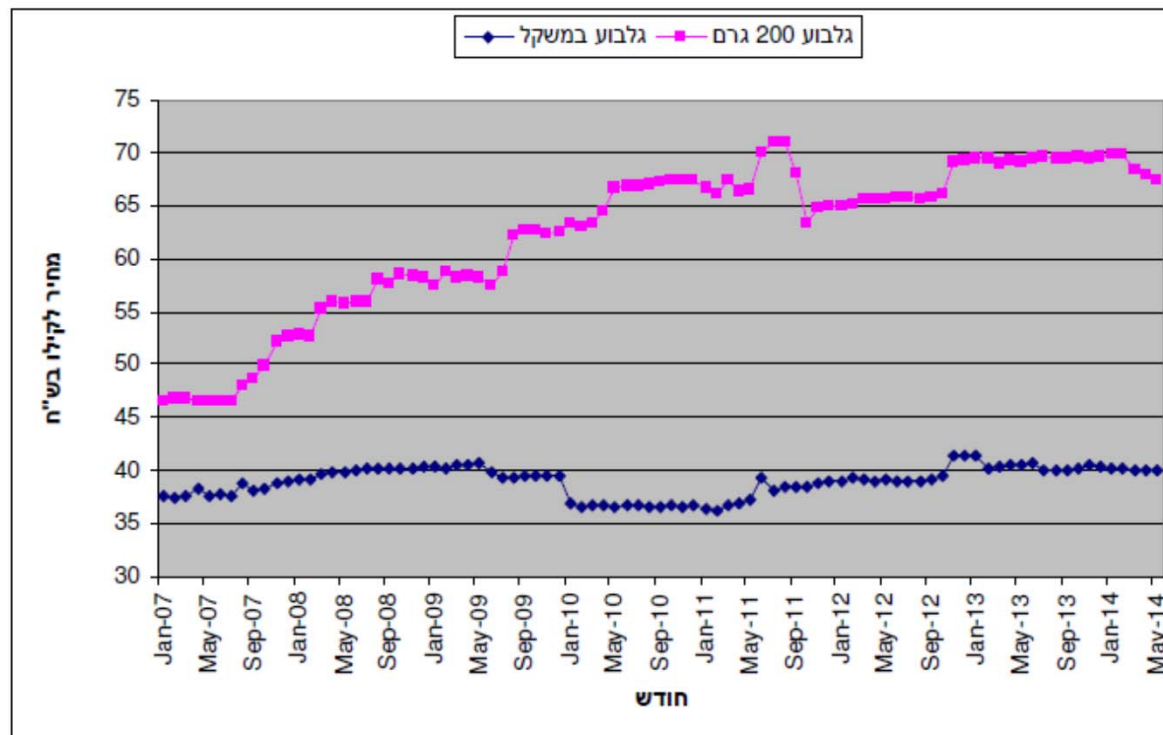
The Tnuva yellow cheese case

Tnuva - background

- In 2007 the price of several types of packaged yellow cheese was deregulated and prices rose fast
 - Tnuva had over 90% market share
- The Israeli state comptroller heavily criticized the decision to deregulate the price (the decision was made without any factual basis or good explanation and without studying the likely implications and was not reconsidered after prices have increased)
- Israel's consumer council has filed a class action lawsuit against Tnuva claiming that the price of 5 different packaged yellow cheeses is excessive
- A ban on excessive prices can then remedy regulatory failures

The price of Gilboa ("Dutch" style) 200g vs. Gilboa by weight

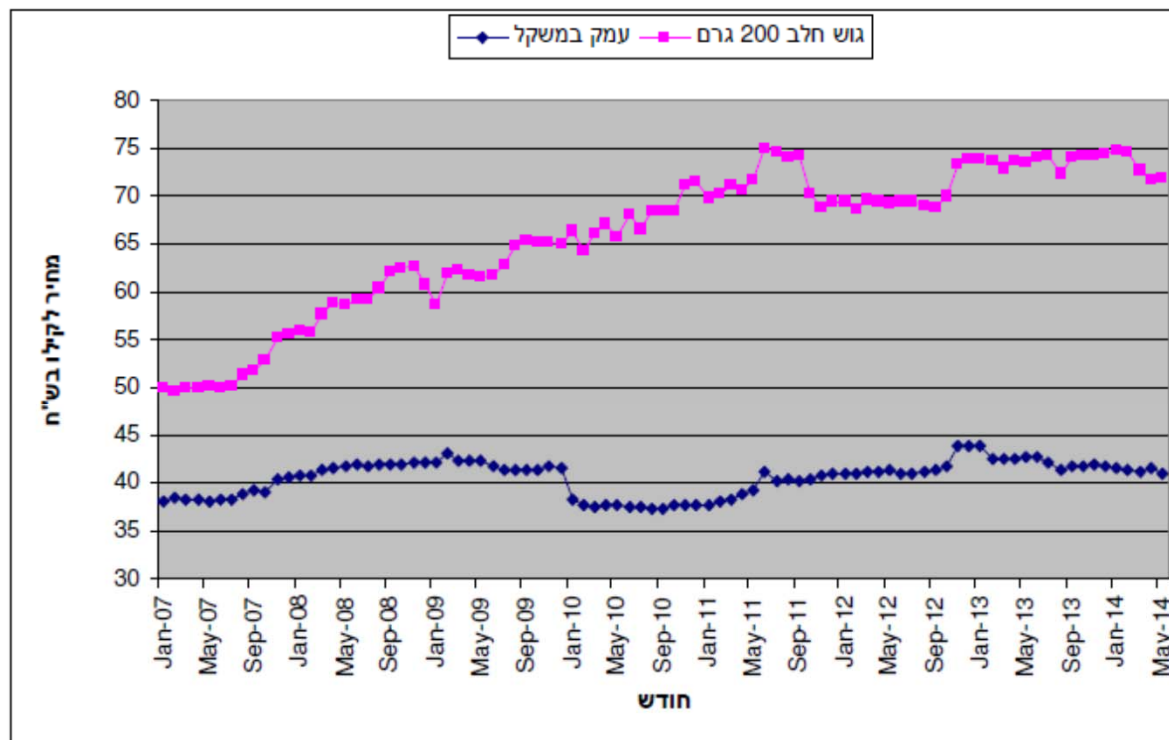
- Packaged Gilboa was deregulated in August 2007; Gilboa by weight is still regulated



מקור: נתוני פאנל הצרכנים של נילסן 2007-2009, ונתוני הקופות של נילסן, 2010-2014

The price of Gush Halav vs. Emek by weight ("Edam" style)

- Packaged Gush Halav was deregulated in August 2007; Emek by weight is still regulated (the two are similar)



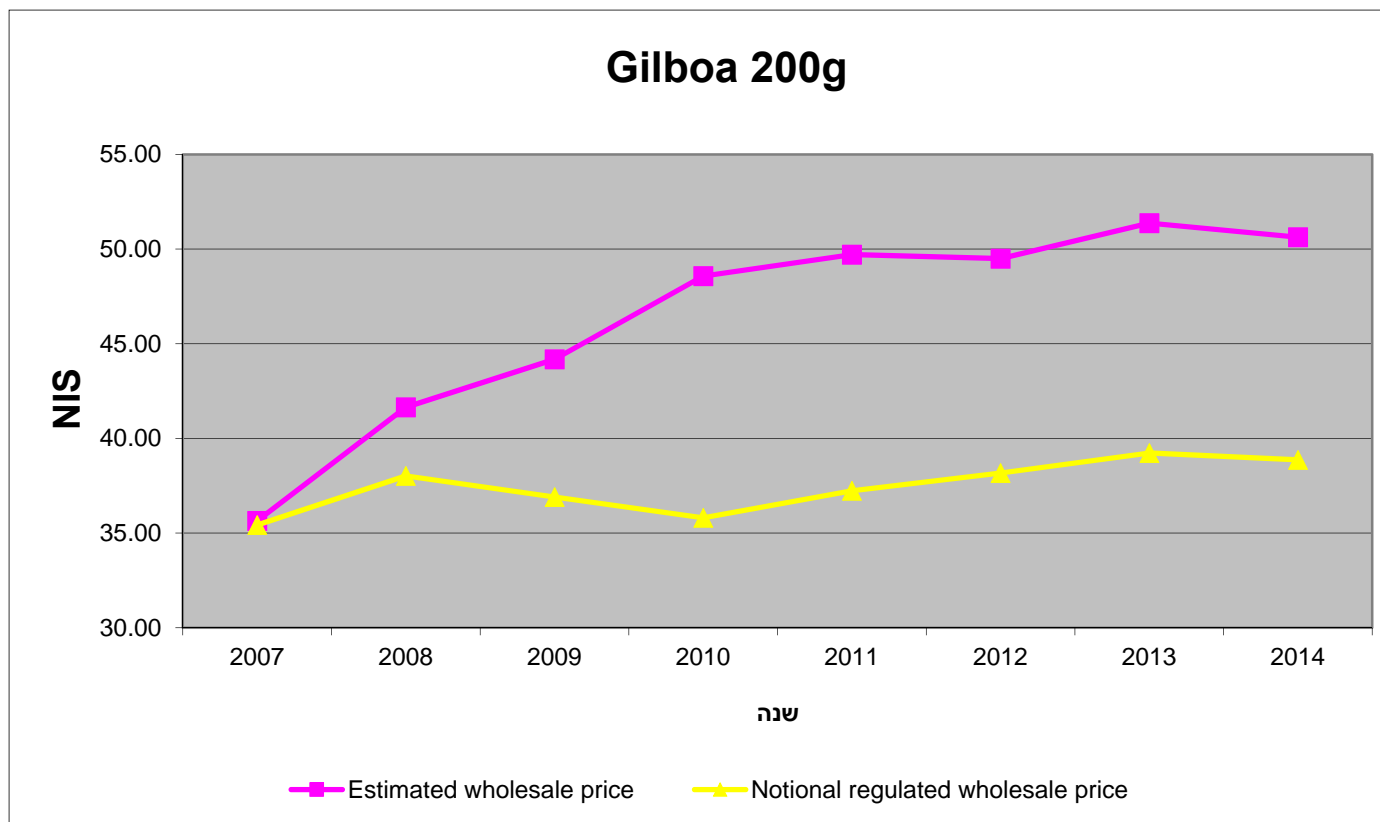
מקור: נתוני פאנל הצרכנים של נילסן 2007-2009, ונתוני הקופות של נילסן, 2010-2014

A benchmark: the notional regulated price

- The notional regulated price is a proxy for the cost of production plus a “reasonable” rate of return
- The notional regulated price of Gilboa 200g (deregulated in July 2007) is the July 2007 price indexed to the price of Gilboa by weight (still regulated)
- Similar idea for other types of cheese
- The wholesale price (which I do not observe) is estimated as the final price minus a retail margin

Gilboa 200g

- The av. excess for 2010-2014 is 32%



Main lessons

- ❑ “Easy” to establish a reasonable benchmark (no doubt that prices have increased after deregulation due to the exercise of market power)
- ❑ No chilling effect: we are talking about yellow cheese...
- ❑ Regulatory failure
- ❑ Entry is unlikely so the problem is not “self-correcting”
- ❑ The main question: is 30% above the benchmark excessive?

The CBC, Coca Cola case

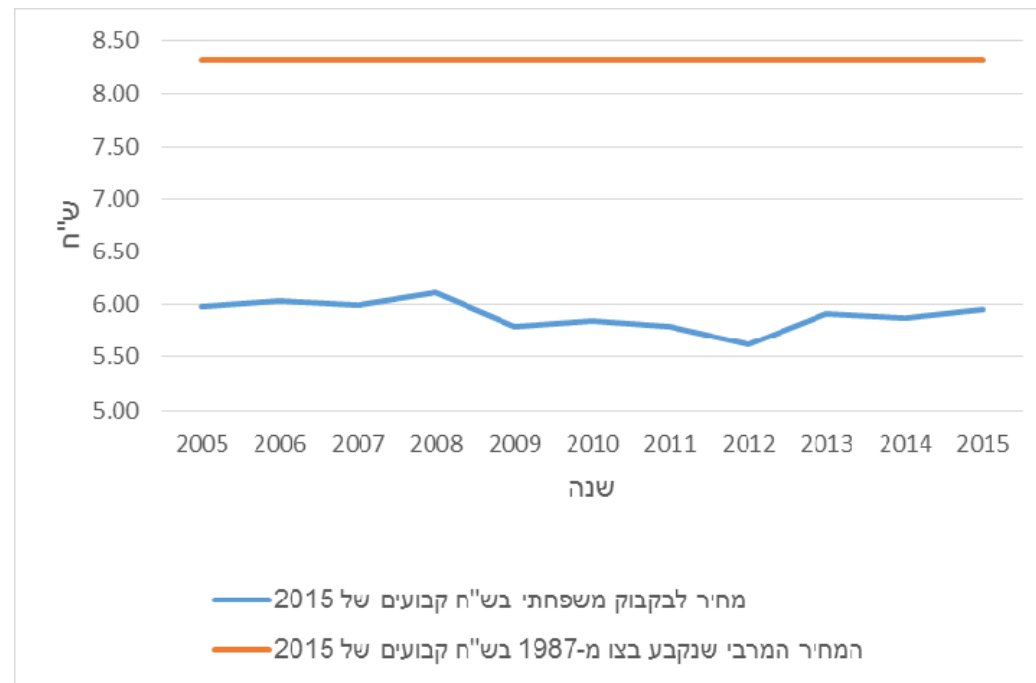
Coca Cola - background

- In late 2018, the district court in Israel certified a class action against the Central Bottling Company (CBC), alleging that the price of 1.5 L bottles of Coca-Cola is excessive (CBC appealed to the supreme court)

- The economic expert for the plaintiff based his opinion on evidence that was available on line for free (“even if it was 500 shekels, I would not buy it.”)
 - The price of Coca-Cola cans in different countries
 - A newspaper article that reported the price of family-sized bottles of Coca-Cola in the US, based on an unknown number of receipts that the journalist received from readers
 - The financial statements of publically traded soft drink producers in Israel and abroad

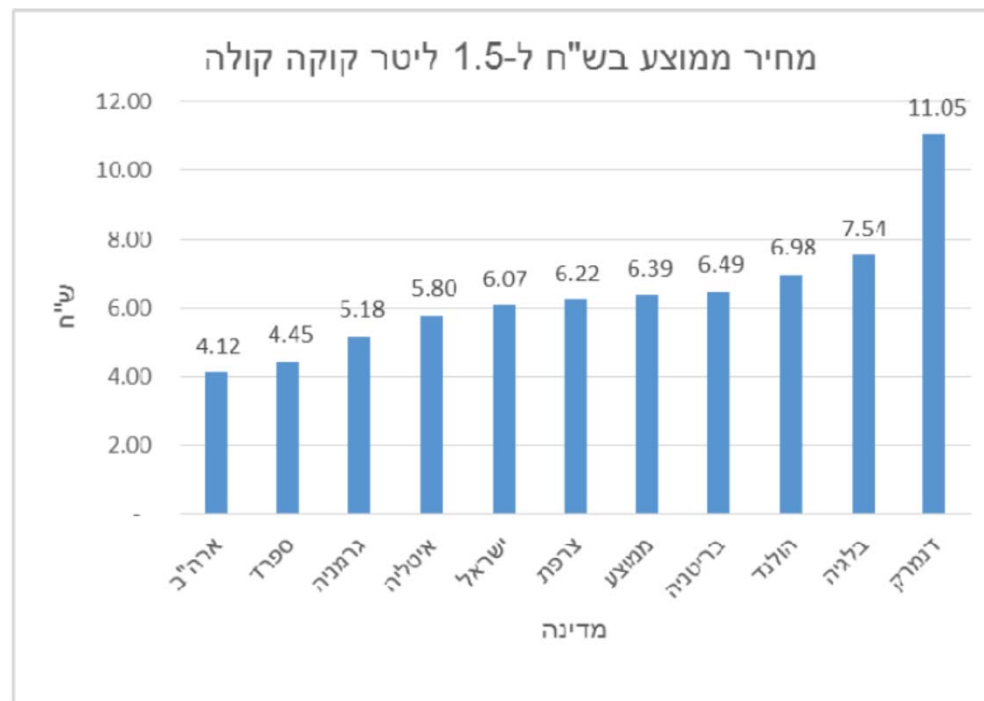
Coca Cola – price over time

- The expert for the plaintiff argued that in the late 1980's the price of Coca Cola was under price control and since deregulation it has increased by 350% (but forgot to mention that inflation rose since then by 462%...)
- The actual price (adjusted for inflation) is in blue and the regulated price from 1987 again adjusted for inflation is in orange; in real terms the price dropped a lot since deregulation



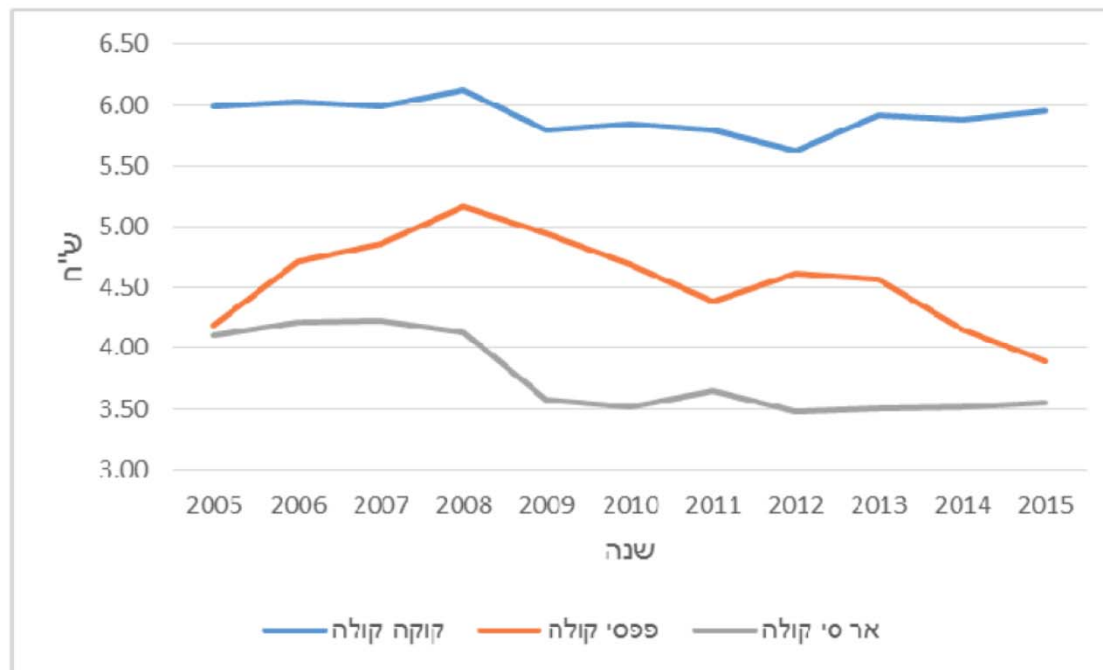
Coca Cola – price across countries

- The price in Israel is 6.07 NIS. It's below the price in France, UK, the Netherlands, Belgium and Denmark though it's above the price in the US, Spain, Germany, and Italy
- Should France, UK, the Netherlands, Belgium and Denmark open a case against Coca Cola? Are courts in Israel smarter and more responsible than in other countries?



Coca Cola

- In the end the judge argued that the fact that Pepsi and RC Cola are cheaper (Coca cola in blue, Pepsi in orange, and RC in grey) is a sufficient indication to certify the class action and that CBC can bring cost data to justify its prices



Conclusion

- ❑ A ban on excessive pricing is a tool to deal with abuse of dominant position
- ❑ It's not a great tool and we do not fully understand its effects
- ❑ A potential solution: go after clear cut cases like Aspen, avoid cases like the Coka Cola case