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Excessive price regulation

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Extended abstract: In the consumers' eyes, excessive pricing is one of the most noticeable and blatant forms of abuse. A bird's eye view of intervention (or non-intervention) against excessive pricing across the world reveals a spectrum of enforcement policies ranging from a clear non-interventionist approach to a moderate approach.

The United States represents a clear example for non interventionist approach. In several instances, the United States Supreme Court has held that U.S. antitrust law does not encompass the charge of high prices.[1] Accordingly, excessive pricing by a dominant firm is not considered a violation and monopolies in the US may demand whatever rates they can obtain in the marketplace.[2]

The European Union has, on the other hand, taken a more interventionist approach. Article 82 of the EC Treaty targets any abuse by undertakings of a dominant position and refers to the possibility that such abuse may consist of: "directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions."[3] The wording "unfair" in Article 82(a) was

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[1] *Berkey Photo, Inc.* v. *Eastman Kodak Co.,* 603 F.2d 263, 274 n.12 (2d Cir. 1979); *Blue Cross & Blue Shield United* v. *Marshfield Clinic,* 65 F.3d 1406, 1413 (7th Cir. 1995); Verizon communications Inc. v Trinco *540 U.S. 398 (2004).*; See also the earlier case of United States v American Can Co., 230 F. 859.

[2] See e.g., 3 Areeda & Hovenkamp, supra note 38, P 720a, at 254-55; see also Chi. Prof'l Sports Ltd. P'ship v. NBA, 95 F.3d 593, 597 (7th Cir. 1996) (overturning a decision that the NBA's telecast fees were too high and noting that "the antitrust laws do not deputize district judges as one-man regulatory agencies"), Fox (1986) p. 985, 993-cited in Motta and Destreel, Michal Gal, Monopoly pricing as an antitrust offense in the U.S. and the EC: two systems, *Antitrust Bulletin;* Spring 2004, pg. 343.

[3] Article 82(a) Treaty of Rome, In addition the article targets abuse which involves the limitation of production to the detriment of consumers. The Treaty of Rome, thus, provides wide tools for the regulation of price. This approach may be explained by some as part of the context in which the treaty emerges, as an attempt to facilitate trade and equality between member states.

held by the European Courts and Commission to encompass excessive pricing.[4] EU jurisprudence generally describes excessive pricing as one that has no reasonable relation to economic value.[5]

The practical difficulties in establishing the excessiveness of price, coupled with the Commission's limited success on appeal, have contributed to the small number of excessive price cases in Europe. The reluctance to engage in price regulation was echoed in several of the Commission yearly reports on competition policy:

> "(...) the existence of a dominant position is not in itself against the rules of competition. Consumers can suffer from a dominant company exploiting this position, the most likely way being through prices higher than would be found if the market were subject to effective competition. *The Commission in its decision-making practice does not normally control or condemn the high level of prices as such.* Rather it examines the behaviour of the dominant company designed to preserve its dominance, usually directly against competitors or new entrants who would normally bring about effective competition and the price level associated with it" (our italics).[6]

Illustrative in this respect are comments made by Philip Lowe, Director General DG Competition who indicated that the European Commission will only intervene when the pricing abuse is not self correcting:

> "…we are obviously aware that in many markets intervention by a competition authority will not be necessary. We are also aware that it is extremely difficult to measure what constitutes an excessive price. In practice, most of our enforcement focuses therefore as in the US on exclusionary abuses, i.e. those which seek to harm consumers indirectly by changing the competitive structure or process of the

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[4] See for example the ECJ decisions in Sierna v Eda [1971] ECR 69; Case 26/75 *General Motors* v *Commission* [1975] ECR 1367; Case 27/76 United Brands v Commission of the European Communities [1978] ECR 207 appeal on Commission decision OJ [1976] L95/1; Also see Commission decisions: COMP/C-1/36.915 British Post office v. Deutche Post AG [2001] OJ L331/40; [2002] 4 CMLR 17; In Dualles System Deutchland AG 2001/463 [2001] OJ L166/1 In British Leyland OJ [1984] L 207/11; In SACEM the ECJ, on an Article 234 reference, considered among others, claims of excessive prices charged made by SACEM on royalties' payments from French discothèques.

[5] Case 27/76 United Brands v Commission, [1978] ECR 207 ; Case 26/75 General Motors v Commission [1975] ECR 1367.

[6] XXIVth Commission Report on Competition, Policy 1994, para 207; See also the Vth Commission Report on Competition Policy 1975, para 76; XXVIIth Commission Report on Competition Policy 1997, para 77.

> market…..And in my view, we should continue to prosecute such practices where the abuse is not self correcting, namely in cases where entry barriers are high or even insuperable. It probably makes also sense to apply these provisions in recently liberalized sectors where existing dominant positions are not the result of previous superior performance.'[7]

Article 82 EC filtered into the legal systems of the Member States both through its direct effect in national courts, and through the design of national competition laws that mirror Article 82 provisions. A large number of member states have thus imported the language of Article 82 EC and, at least in theory, provided a legal basis for prohibition of excessive pricing. In practice, the level of intervention varies across the member states.

In the *United Kingdom*, for example, Section 18 of the UK Competition Act mirrors the provisions of Article 82 and provides for the regulation of excessive pricing. UK guidelines and practice provide for a restrictive approach. According to the Office of Fair Trading Guidelines on Assessment of Individual Agreements and Conduct elaborate, excessive pricing is established when the undertaking is able to sustain profits higher than it could expect to earn in a competitive market (supra-normal profits) and when these profits are not explainable as the result of market competition, efficiency or innovation.[8] Measurement of supra-normal profit may involve a number of ways, among them a cost/revenue comparison, return on capital/weighted average cost comparison or a comparison of the "certainty equivalent accounting rate of return" over a number of years with the risk free rate of interest.[9] This lenient approach towards dominant firms is based on the ability of the market to correct itself and thus limit the cases where intervention is merited:

> The Director General will be mindful of the need not to interfere in natural market mechanisms where high prices will encourage new entry or innovation and thereby increase competition. In such markets, excessive prices will be regarded as

[7] Philip Lowe, Director General DG Competition 'How different is EU anti-trust? A route map for advisors – An overview of EU competition law and policy on commercial practices' [Speech] ABA 2003 Fall Meeting.
[8] OFT 414.
[9] OFT paras 2.14 – 2.19; Also see Martin Graham, Anthony Steele, The Assessment of Profitability by Competition Authorities, [1997] OFT research paper No. 10

> an abuse only where it is clear that high profits will not stimulate successful new entry within a reasonable period.[10]

In its draft guidelines on Assessment of Conduct,[11] the OFT provides a list of possible benchmarks which may be used to assess whether prices are excessively high. These include comparisons with prices of the same products in different markets, comparison with prices in another time period and cost-price assessment. The guidelines list a range of indicators which would usually be considered when evaluating the excessiveness of price and the undertaking's profitability.[12]

The Netherlands is another example of a member state that adopted a more interventionist approach to excessive pricing. Like the UK Competition Act, the Dutch Competition Act (*Mededingingswet*), which entered into force on 1 January 1998, closely follows the EC system. Article 24 of the Act prohibits the abuse of a dominant position and includes a prohibition for imposing unfair excessive prices. In contrast to the lenient approach toward the dominant firm taken by the UK OFT, the Dutch Competition Authority (*Nederlandse Mededingingsautoriteit*) (DCA) has taken a rather interventionist approach when scrutinizing prices.

In this paper we wish to focus on one particularly interesting benchmark that can be used to prove excessive pricing by a dominant firm, namely, a significant price cut by an incumbent firm following entry into its market. This way of exposing excessive pricing is particularly interesting because, on one hand, it is a relatively easy to apply, but, on the other hand, it affects the incumbent and entrant's incentives in a non-trivial way. In order to examine how the prohibition of excessive pricing by the incumbent firm affects consumers when excessive pricing is revealed through the incumbent firm's post-entry price cuts, we consider the following two-period model. The incumbent firm acts as a monopoly in the market in period 1, but can face competition from an entrant in period 2. Under a prohibition of excessive pricing, the incumbent firm knows that if it prices excessively in period 1, and then cuts its price in period 2 in response to entry, it faces the risk of being prosecuted for charging excessive prices in period 1.

We show that the prohibition of excessive pricing by the incumbent firm may affect consumers in four possible ways. First, the incumbent firm may hesitate to significantly cut

[10] OFT 414 para 2.13
[11] OFT 414 a
[12] Paras 2.7 - 2.15.

prices following entry, in order to minimize the risk of being prosecuted for charging excessive prices in period 1. This effect obviously could harm consumers. Second, anticipating the soft behavior of the incumbent firm in response to entry, the entrant may charge higher prices upon entry. This effect reinforces the first negative effect of excessive price prohibition. Third, the incumbent firm may charge lower prices in period 1, before entry takes place, in order to give it more freedom to cut prices following entry without exposing itself to excessive pricing claims. Unlike the first two effects, this effect benefits consumers. Finally, precisely because the incumbent is more reluctant to cut prices after entry, the entrant may find entry profitable even when absent the prohibition of excessive pricing he would have found entry unprofitable. Like the third effect, the last effect also benefits consumers.

The aim of the paper is to study the interplay between these four effects. In particular, we are interested to examine the economic conditions and the legal rules under which exceesive price prohibition is pro-competitive and benefits consumers and the economic conditions and legal rules under which it is anticompetitive and harmful to consumers. Among other things, we consider the probability that the incumbent firm will be successfully prosecuted, the intensity of the post entry competition between the incumbent firm and the entrant, the size of the post entry price reduction which is sufficient to trigger an excessive pricing claim, and the size of the fine imposed on the incumbent firm if it is convicted.

We also consider extensions of the basic model in which the incumbent is attacked by the entrant for charging predatory pricing in period 2 rather than being attacked by consumers for charging excessive pricing in period 1. In this case, the “fine” that the incumbent pays if convicted is paid to the entrant, and is proportional not to the incumbent’s excessive profits in period 1 but to the entrant’s lost sales due to the post-entry price cut.

In another extension we consider the case where, rather than enter with some exogenously specified probability, the entrant entry decision is endogenous – the entrant decides to enter only if he expects to make positive profits in the market. This extension allows us to examine the pro-competitive effect of excessive price regulation that comes from the fact that entry is encouraged by the regulation since it turns the incumbent into a softer competitor in period 2 when entry takes place.