REASONABLE RELATIONSHIP OR ABUSE?
WHEN IS A PRICE UNREASONABLE UNDER SECTION 8(A)?

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I. INTRODUCTION

Excessive pricing is perceived to be amongst the most egregious and exploitative behaviour that can be undertaken by a dominant firm. The gravity of the contravention is evident when one considers that excessive pricing is one of only five prohibitions for which first time offenders can be levied an administrative fine (of up to 10% of annual turnover). Yet excessive pricing is also a concept troubled by a great deal of both methodological and conceptual uncertainty.

An excessive pricing investigation under Section 8(a) requires the determination of whether a price charged by a dominant undertaking bears a reasonable relationship to economic value. While there appears to be at least some convergence of opinion on the appropriate methods for determining economic value, there is still significant uncertainty on the tolerance allowed between prices and economic value (i.e. a reasonable relationship). The quite nuanced and extreme stance adopted by the Tribunal in the recent Sasol Polymers decision has not bought clarity to this matter, and in some respects has only served to raise further questions as to what constitutes a reasonable relationship between prices and economic value. Meanwhile, firms remain unclear as to what constitutes an excessive price in terms of the Competition Act, and how to balance this with the mandate from shareholders to maximise profits.

Arguably, the tolerance level between prices and economic value should be material as the consequence of errors and over-enforcement are substantial. In this paper, we argue against a single prescribed tolerance level for all cases. Rather, we argue that the tolerance level should depend on a number of factors, including the nature of the market being considered and the circumstances particular to a case. Clear principles and guidelines for thinking about "reasonableness" can be established to bring much needed clarity for firms operating in South Africa. We detail key factors and a framework for determining reasonableness when assessing complaints under section 8(a).

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II. EXCESSIVE PRICING UNDER THE SOUTH AFRICAN COMPETITION ACT

Section 8(a) of the South African Competition Act ("the Act") prohibits a dominant firm to "*charge an excessive price to the detriment of consumers."*[2] An *excessive price* is defined in section 1(1)(ix) of the Act as *"a price for a good or service which (aa) bears no reasonable relation to the economic value of that good or service; and (bb) is higher than the value referred to in subparagraph (aa)."*

The South African Competition Appeal Court ("the CAC") in *Mittal Steel South Africa Limited and others v Harmony Gold Mining Company and another* found that the wording of section 8(a) read together with the definition of an excessive price requires the Tribunal to engage in four distinct factual determinations[3]:

(i) first, to determine the actual price of the good or service alleged to be excessive;

(ii) second, a determination of the *economic value* of that good or service expressed in monetary terms;

(iii) third, a value judgement as to whether the actual price is higher than the economic value and whether the *difference is unreasonable;*

(iv) fourth, whether the charging of that price is to the detriment of consumers.

The "*economic value*" of a product and the "*unreasonable difference*" between price and economic value are probably the two most central – and indeed contested –analytical elements to assessing an excessive price allegation. We discuss the definition and application of each of these concepts in the sections that follow.

Economic Value

The lack of formal definition in the Competition Act requires case precedent to clarify how the term "economic value" should be interpreted. Whilst much uncertainty remains, some progress has indeed been made on this front – primarily through the CAC's *Mittal* judgement. Here the CAC indicated that the legislature must have intended the economic value of a good or service to be "*the notional price of the good or service under assumed conditions of long-run competitive equilibrium."*[4] Drawing from the insights provided by the CAC in *Mittal,* it appears that economic value should encapsulate the following elements:

[2] The South African Competition Act of 1998, as amended, Section 8.
[3] Competition Appeal Court of South Africa, Mittal Steel South Africa Ltd vs Harmony Gold Mining Company, Case 70/CAC/Apr07, para. 32.
[4] *Ibid,* para. 40.

(i) The economic value of a good would at a minimum be equal to the total cost of providing the good or service as well as the inclusion of a "*normal rate of return*" to the providers of capital.[5]

(ii) The calculation of economic value relates to the costs faced by the firm in a long-run competitive market and is not peculiar to the particular firm. As a result, the firm's own costs are a useful starting point when estimating the economic value of a product but "*they will not in and of themselves provide a measure for arriving at economic value unless they can show to correspond to the competitive norm."*[6]

(iii) Economic value of a good or service should reflect the value of a good or service in a market characterised by no barriers to entry where firms can freely enter the market in the event of a higher than normal rate of return and exit the market when the return is below the normal rate.

As a result, a factual enquiry into the costs actually incurred by a firm is a core element in determining the economic value of a good or service. The prominent methods accepted by South African competition authorities for comparing prices to economic value are price-cost tests, profitability analysis and pricing comparisons.

Price-cost tests compare prices to total economic costs. Economic costs are the firm-specific accounting costs (i.e. operating costs and depreciation) with an additional allowance for a normal rate of return on the capital employed by the firm. In *Mittal*, the CAC provided support for the price-cost test where it held that "*there may be no alternative to a detailed exercise in comparative costing. If expert evidence has been given concerning costing data, the necessary adjustments to be made for comparative purposes, the appropriate methodology needed to establish the opportunity cost of capital and allow for depreciation and replenishment of plant etc. then findings based on an evaluation of that evidence will have to be made."*[7][8]

Profitability analysis is a variant of price-cost tests and involves the comparison of the returns on capital employed (IRR, ROCE) to the weighted average cost of capital

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[5] *Ibid,* para. 40.
[6] Competition Appeal Court of South Africa, Mittal Steel South Africa Ltd vs Harmony Gold Mining Company, Case 70/CAC/Apr07, footnote 70.
[7] Competition Appeal Court of South Africa, Mittal Steel South Africa Ltd vs Harmony Gold Mining Company, Case 70/CAC/Apr07, paragraph 52.
[8] Under specific circumstances, a comparison of the difference between domestic prices and export prices can form a basis for determining whether a price is excessive or not. The CAC held in *Mittal* that if there is a difference between domestic and export prices and a firm embarks on an expansion of its production capacity in order to increase its export sales, it would be difficult to conclude that export prices are not at or above economic value. See The Competition Commission of South Africa v Sasol Chemical Industries, Case 48/CR/Aug10, paragraph 317.

(WACC) of the firm producing the good or service in question. Firm specific costs can be used under the assumption that these costs represent a good proxy for the relevant economic costs in a long run competitive equilibrium, as held by the CAC in *Mittal*.[9]

Pricing comparisons, which are less burdensome relative to the complex profitability assessments, would entail comparing prices of the good in question to the prices of similar products in more competitive markets. In this regard, the CAC stated in *Mittal*: *"Prices ordinarily charged locally in other markets by the same firm or by other firms with broadly comparable cost structures at comparable levels of output, may obviously serve as a measure of the 'economic value' of the same good or service in our market – if the other markets are shown to be, or can be assumed to be, characterised by effective competition in the long run."*[10,11]

Given the complexities involved in estimating economic value in the cost-based methods, an acceptable determination of whether prices are excessive should be based on a comparison of the results obtained from the different techniques. The competition authorities can then weigh up the different results and determine whether the collection of evidence jointly finds that a price is excessive. This approach is consistent with both South African and international case law.

The Tribunal followed this logic in the recent *Sasol Polymers case*. It opted against relying on a single comparator when measuring economic value but rather relied on price-cost tests, the comparison of domestic prices to alleged comparable international prices and a comparison of domestic prices and prices charged in export markets.[12]

Internationally, the *United Brands* case established that even if prices failed the price-cost test this was insufficient to find excessive pricing as the price in question would also have to be excessive in itself or with respect to comparators.[13] Further, according to O'Donoghue and Padilla (2006) the consideration of different techniques was also

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[9] Competition Appeal Court of South Africa, Mittal Steel South Africa Ltd vs Harmony Gold Mining Company, Case 70/CAC/Apr07, footnote 70.

[10] Competition Appeal Court of South Africa, Mittal Steel South Africa Ltd vs Harmony Gold Mining Company, Case 70/CAC/Apr07, paragraph 51.

[11] The *Mittal* judgment also refers to another determination of economic value in paragraph 52: *"When a lower price (eg, a rebated local price or an ex-works export price) is said to be sufficient to 'cover costs', it is important to establish that the price concerned covers not merely the accounting costs but also the relevant opportunity costs of capital. Where a dominant domestic producer maintains price differentiation between export and domestic customers, and embarks on an expansion of its production capacity wholly or mainly in order to increase its export sales, then it would be difficult to avoid the conclusion that its export price would be at or above economic value – at the expanded level of output intended."*

[12] The Competition Commission of South Africa v Sasol Chemical Industries, Case 48/CR/Aug10, at pars. 125-126, 316 and 358.

[13] "*The questions therefore to be determined are whether the difference between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products."* Case IV/26.699, United Brands Commission Decision of 17 December 1975 and Case 27/76, United Brands v Commission [1978] ECR 207, para.252 (emphasis added).

applied in *Napp*[14], where the excessive pricing investigation *"consists of using several cost, price, and profitability benchmarks simultaneously in order to verify the legitimacy of a given pricing policy."*[15] The OFT also codified this approach in the draft guidelines on the Assessment of Conduct where it stated that *"to demonstrate that excessive prices had been set several indicators would usually be considered..."*[16]

Reasonableness

While there appears to be at least some convergence on the appropriate methods for determining economic value, there is significant uncertainty and ambiguity on the tolerance allowed between prices and economic value (i.e. a reasonable relationship). Firms remain unsure as to the magnitude at which prices above economic value become unreasonable, and therefore, in contravention of the Competition Act.

In *Mittal* the CAC offered very little guidance as to what might constitute a reasonable relationship between economic value and prices. It suggested that the tolerance level might be dependant to some degree on factors peculiar to the dominant firm such as the existence of special cost advantages.[17]

In *Sasol Polymers,* the Tribunal considered in more detail whether the observed prices were reasonably related to economic value. In this instance the Tribunal considered a range of firm and case-specific factors such as the dominance of Sasol; barriers to entry; the homogeneity of the product; cost advantages of Sasol; the extent of innovation and risk taking by Sasol; the extent of state support enjoyed by Sasol and the impact on downstream industries and the economy. [18] Based on these factors the Tribunal appeared to take the extreme stance of not allowing for <u>any</u> tolerance of prices above economic value. In this regard the Tribunal stated:

> *"The above features are not reflective of competitive markets and we conclude that there is no basis for SCI to be rewarded by being permitted to make returns*

[14] Case CA98/2/2001, Napp Pharmaceuticals Holdings Ltd and Subsidiaries, Decision of Director General of Fair Trading [2001] and Case 1001/1/1/01, Napp Pharmaceuticals Holdings Ltd and Subsidiaries v Director General of Fair Trading, CAT [2002].
[15] O'Donoghue, Robert and Padilla, Jorge. 2006. *The Law and Economics of Article 82 EC*, Hart Publishing, pages 632-633.
[16] Office of Fair Trading (2004) *Assessment of Conduct: Draft competition law guideline for consultation*. OFT 414a, para. 2.8.
[17] Competition Appeal Court of South Africa, Mittal Steel South Africa Ltd vs Harmony Gold Mining Company, Case 70/CAC/Apr07, paragraph 43. Here the CAC stated at the stage of evaluating reasonableness that "…*circumstances peculiar to the particular dominant firm would rationally come into the reckoning. It would seem sound, when considering whether the higher price bears a reasonable relation to economic value or not, to take into account the benefits flowing to the firm from the subsidized loan, long-term low rental, or other special advantage which may serve to reduce its own long-run average costs below the notional norm."*
[18] The Competition Commission of South Africa v Sasol Chemical Industries, Case 48/CR/Aug10, para. 413

above 'normal' profits."[19] [Where the concept of earning 'normal' profits is equivalent to pricing at economic value.]

However, in applying this radical approach to the "reasonableness" assessment the Tribunal did not offer a framework for how one should evaluate the relationship between prices and economic value. In our view, the Tribunal's approach remains controversial and does not provide much additional clarity for dominant firms (nor practitioners for that matter).

The Tribunal's approach contrasts to international approaches to determining the relationship between economic value and prices (which is discussed in more detail in the following section). It also contrasts to a previous opinion by the Competition Commission regarding the tolerance level between prices and economic value. For example, the Commission's 2003 report to the DTI stated that *"[it] still remains the question of what constitutes an excessive rate of profit? It might be decided as a rule of thumb that rates of return would have to be at least 50% above the national average before they could be considered as corresponding to the charging of excessive prices."* [20]

The assessment of reasonableness is further complicated due to the potential varying degrees of excessiveness that result from the different methods for comparing prices to economic value. Here, different methods (price-cost vs. profitability analysis) can yield vastly different levels of "excess". This potential outcome is illustrated in the example below.

Assuming the following variables:

- Asset value (capital employed): R1 000 million
- Volumes (units): 1 million
- Revenue: R500 million
- Opex + depreciation: R350 million
- WACC: 10%

[19] The Competition Commission of South Africa v Sasol Chemical Industries, Case 48/CR/Aug10, para. 414.
[20] Competition Commission of South Africa Final Report to the Department of Trade and Industry on Import Parity Pricing (November 2003). Available online: http://www.healthinquiry.net/Public%20Submissions/Netcare%20Ex%20GH-13%20Competition%20Commission%20final%20report%20on%20import%20parity%20pricing.pdf [Last accessed: 5 March 2015]

A profitability test would yield a return on capital employed (ROCE) of 15 per cent.[21] This implies the ROCE would be in excess of WACC by **50 per cent**. Alternatively, under the price cost approach, the price would equal R500[22] and the cost R450 per unit[23] – which implies an excess of **11.1 percent.** This hypothetical example demonstrates that the same tolerance level will result in different conclusions on reasonableness when using the profitability analysis versus the price-cost test.

III. INFERENCES FROM CASE LAW ON REASONABLNESS

The interpretation of a reasonable relationship under the South African Competition Act can be guided when one considers what the EU regards as a difference substantial enough to establish an abuse.

Table **1** summarises key EU cases where excessive pricing allegations were considered. The following observations are noteworthy.

i. Competition authorities have generally found excessive pricing in instances where substantial differences exist between the prices in question and comparators. OFT Guidelines state that "*in assessing questions about excessive pricing, the OFT would usually look for evidence that prices are substantially higher than would be expected in a competitive market.*"[24] For example, in *British Leylands* the difference was six times greater than comparable products and in *Napp* prices charged to the community were 1400% higher when compared to prices charged to hospitals and 500% higher than export prices.

ii. Modest differences observed in price comparisons are not usually regarded as excessive. For example, in *United Brands* the ECJ held that a 7% difference was not considered excessive.[25]

iii. There is no single threshold or tolerance level for the reasonableness assessment which emerges from the assessment of the European case law.

iv. Most of the cases presented in

[21] ROCE: (500 – 350) / 1000
[22] 500,000,000 / 1000,000
[23] (350,000,000 + 100,000,000) / 1000,000
[24] Office of Fair Trading. 2004. *Assessment of Conduct: Draft Competition Law Guidelines for Consultation.*
[25] "*Although it is also true that the price of Chiquita bananas and those of its principal competitors is different, that difference is about 7%, a percentage [...] which cannot automatically be regarded as excessive and consequently unfair."* Case IV/26.699, United Brands Commission Decision of 17 December 1975 and Case 27/76, United Brands v Commission [1978] ECR 207, paragraph 266.

v. Table **1** involved additional exclusionary abuse. For example, *British Leyland* dealt with preventing parallel imports and intra-brand competition, *Napp* excluded competitors through selective discounts and *Deutsche Post* dealt with preventing re-mail companies from entering the market.

vi. Key decisions in *Attheraces*[26] and *Port of Helsingburg*[27] (not included in Table 1 as the respondents in these cases were not deemed to have priced excessively) emphasised the need to identify intangible benefits that may not be reflected in the normal calculation of economic costs. In *Attheraces*, the English Court of Appeal stated that the economic value of horseracing data was not merely the cost of production plus a reasonable return, but also included the value of the data to betting broadcasters.[28] In *Port of Helsingburg v Scandlines*, the EC Commission determined that the benefits of a port's favourable location and superior rail linkages need to be taken into account in the determination of economic value.[29]

Table 1: Reasonableness in EU case precedent on excessive pricing

Case	Test for excessiveness	Alleged price differentials that constitute an abuse
Deutsche Grammophon (ECJ)	Price comparisons	"Particularly marked difference"
British Leyland (Comm. And ECJ)	Price of comparable service	"Six times greater" for comparable products
SACEM (ECJ)	Price comparison	Several times higher
Bodson (ECJ)	Price comparison	Prices of others "markedly lower"
Deutsche Telecom (Com)	International price comparisons and cost/ price differences	100% difference compared to comparable competitive markets
Deutsche Post Commission (Com)	Price-cost comparison	Price exceeded its average economic value by at least 25%
NAPP Pharmaceuticals (OFT UK)	Price-cost comparison/ comparison to competitor prices/ comparison to prices charged by the dominant firm in other markets	A profit margin of more than 80% was earned from sales to community and in excess of 10% when compared to next closest competitor/ Prices were 40% higher than the next highest priced competitor/ Prices to the community segment were on average 1400% more than prices charged to hospital and 500% higher relative to export prices.

Source: Deutsche Grammophon Gesellschaft mbH v. Metro-SB-Gro market GmbH & Co, Case 78/70, (1971) ECR 487.

British Leyland Plc. v. Commission, Case 226/84 (1986) ECR 3263 (1987) 1 CMLR

Ministere Public v. Tournier, Case 395/87 (1989) ECR 2521, [1991] 4 CMLR 248 ("SACEM II"), Joined cases 110, 241 and 242/88 Lucazeau v. SACEM [1989] ECR 281 ("SACEM III").

Bodson v. Pompes Funebres, C-30/87 (1988) ECR 2479, [1989] 4 CMLR 984.

Deutsche Telekom, EC Commission 27th Report on Competition Policy, section 77 (1997).

NAPP Pharmaceutical Holdings Limited and Subsidiaries, (NAPP) v Director General of Fair Trading, CA98/2/2001 (2001)

[26] Case A3/2006/0126, Attheraces Ltd v. The British Horseracing Board Ltd & Anor, [2007] EWCA Civ 38
[27] Commission of the European Communities, Scandlines Sverige AB vs Port of Helsingborg, Case COMP/A.36.568/D3,
[28] Case A3/2006/0126, Attheraces Ltd & Anor v. The British Horseracing Board Ltd & Anor, [2007] EWCA Civ 38. paragraphs 210 and 215.
[29] Commission of the European Communities, Scandlines Sverige AB vs Port of Helsingborg, Case COMP/A.36.568/D3, paragraphs 209 and 210.

Deutsche Post AG v Commission, Comp/C-1/36.915 (2001) EC 892

IV. KEY FACTORS FOR DETERMINING THE REASONABLENESS THREASHOLD

A single prescribed tolerance level between prices and economic value should not necessarily be universally applied across all cases. Rather, in our view, there may be scope for this tolerance level to differ from case to case depending on the specific facts of each matter. This was clearly the expectation of the CAC in *Mittal*.[30] It was also the view of the Tribunal in *Sasol Polymers*.[31] However, this must be balanced against a desperate need to provide clarity to firms, and to develop a coherent, predictable and workable framework for assessing excessive prices. In our view, this framework should hinge on two key elements:

- Firstly, there must be at least <u>some</u> non-trivial allowance, in all cases, for prices to legitimately exceed economic value.
- Secondly, the actual tolerance level for prices to exceed economic value could differ from case to case depending on a set clearly defined and predictable criteria.

In the sections below we expand on each of these key elements.

A degree of tolerance should always be allowed

From a natural – and even very cursory – reading of the Competition Act it would seem apparent that a price can only be problematic under section 8(a) when it <u>exceeds</u> the benchmark of economic value. For example, by definition a price can only be deemed excessive if it "*bears no reasonable relation*" and is "*higher than*" economic value.[32] The language in the Competition Act would also suggest that an excessive price would need to exceed economic value by a significant margin to meet the requirement of "*no reasonable relation*". This minimum bar of a non-trivial divergence between prices and economic value is further indicated when one considers the following factors:

i. International precedent suggests that competition authorities have generally found excessive pricing in instances where <u>substantial</u> differences exist between prices and comparators (i.e. economic value). For example, United Brands cited price margins of over 100%; British Leyland pointed to price differences of over

[30] Competition Appeal Court of South Africa, Mittal Steel South Africa Ltd vs Harmony Gold Mining Company, Case 70/CAC/Apr07, paragraph 43.
[31] The Competition Commission of South Africa v Sasol Chemical Industries, Case 48/CR/Aug10, para. 404-414.
[32] The Competition Act, Chapter 1, Section 1.

500%; SACEM cited prices several times higher than the comparisons; ITT Promedia cited margins of over 900% etc.[33] The OFT guidelines also indicate that they would usually look for evidence that prices are "substantially" above competitive prices.

ii. Estimating economic value can be notoriously difficult and complex. For example, when using the price-cost test or profitability analysis the determination of relevant costs typically relies on a number of assumptions and can be prone to measurement errors. The outcome of such an analysis can also be impacted by methodology used, for which a number of reasonable alternatives may exist. Estimating economic value through "shortcut" measures that fall short of a full cost analysis can also be prone to measurement error and often are most helpful in providing a broad steer rather than a specific calculated result. For example, it can be very difficult to find appropriate comparators for international price comparisons. This margin for error implies that if tolerance levels are non-existent, or are set too narrowly, then there is a real risk of over enforcement or type I errors in excessive pricing cases.[34] These errors can be very costly for businesses and could have a dampening effect on genuine and legitimate economic activity. The need for some tolerance to account for error in determining economic value was recognised by the Tribunal in Sasol Polymers – but oddly it did not seem to flow through to their analysis of that case. [35]

iii. Firms' prices can fluctuate significantly over time and are often influenced by local and international business cycles or global commodity prices. There is also the possibility that prices be impacted as a result of short run and unexpected exogenous shocks, for example a sudden increase in local demand. In these instances, although prices may exceed economic value in the short run, the difference between price and economic cost may be self-correcting in the longer run. Two possibilities exist. First, the firm may expand capacity in the face of increased demand thus incurring additional costs which would bring prices more in line with costs. Second, if the industry is characterised by low entry barriers, entry may result in a price reduction. Therefore, a margin of tolerance is required so as exclude cases where prices are above economic value due to temporary and self-correcting market shocks.

[33] For further details on these international cases see Table 1.
[34] A type I error occurs when a given result appears to be present when it actually is not. In the context of excessive pricing, a type I error will occur when a firm is found to have charged excessive prices but in reality did not.
[35] The Competition Commission of South Africa v Sasol Chemical Industries, Case 48/CR/Aug10, para. 399.

iv. Long run average incremental costs (LRAIC) and fully allocated costs (FAC) measures can be used in the determination of economic value when applying the price-cost test.[36] However, these measures are also used as cost benchmarks in assessing allegations of predatory pricing. Thus some pricing flexibility above these measures is needed to avoid them being used as both a price ceiling and a price floor.

v. Finally, a prospect of no tolerance between prices and economic value leaves dominant firms highly uncertain as to whether their pricing falls foul of the Competition Act or not. This is despite the very serious nature of a section 8(a) contravention - it carries a potential fine of up to 10% of turnover, even for first time offenders.

For these reasons the notion of zero-tolerance, advocated by the Tribunal in *Sasol Polymers,* seems inappropriate. Rather, there is a strong case for a minimum tolerance level (over economic value) under which firms and authorities can have a degree of certainty that no contravention of section 8(a) has occurred. In identifying the minimum level, regard could be given to the higher returns firms seek when assessing the viability of new investments, particularly in new markets. These higher returns are often termed “hurdle rates”. According to a 2012 PWC survey, approximately 73% of firms use hurdle rates to account for project specific risks.[37] Another approach would be to refer to judgments made in European excessive pricing cases (e.g. see *United Brands and NAPP).*

Based on these two approaches, we believe a minimum threshold of least 10 per cent (over economic value) should apply in South Africa. This minimum could very well be higher as the maximum tolerance allowed by the ECJ with regards to excessive pricing remains unclear. The minimum should apply even in circumstances where economic value is calculated with a high degree of robustness and confidence, given the adverse consequences to firms from an adverse finding. The extent to which the tolerance level increases beyond this minimum should depend on a number of industry specific factors, which we explain below.

[36] The OECD’s policy roundtable on excessive prices promotes the use of LRAIC as an appropriate comparator in price- cost tests. LRAIC is particularly useful to overcome the complexities of allocating costs, especially common costs.

[37] The PwC report determines the use of hurdle rates by asking respondents the following question: “*Do you adjust the CAPM rate of return by a premium that reflects unique risks to the extent that such risks could not be modelled in the forecast cash flows?*” 30% of responded that they always adjust the CAPM rate of return and 43% of respondents indicating that they adjust the CAPM rate of return. See PricewaterhouseCoopers. 2012. An African Perspective: Valuation Methodology Survey 2012, p. 51.

Tolerance level may vary from case to case depending on a number of factors

From an economic perspective there would be sound grounds for the tolerance level between prices and economic value to vary from case to case depending on the specific facts of the case. Any such variation would need to be predicated on a set of clearly defined and predictable criteria, which we propose as follows.

Dynamism in the market

Market dynamism relates to firms that regularly introduce new products or make significant improvements to existing products in the relevant market. Innovation for the development of new products often requires a substantial amount of commercial risk as well as upfront investment before any commercial gains are realised. As a result, there are winners and losers in dynamic markets as not all new or improved products will gain market share and be successful. In addition there is no guarantee that investing in innovation will yield the desired results.

Consequently, when assessing profitability or comparing prices to economic costs in these types of markets one must consider that there is likely to be a survivor bias in the profitability of the relevant market, that is, the losses from defunct firms would not be captured in the analysis. Furthermore, in relation to the successful firm(s), the costs of unsuccessful research are likely to be excluded in the determination of economic costs of successful products.[38]

It seems to reason that the tolerance level should be higher for markets that have a high level of dynamism. Factors which give an indication of the extent of dynamism include: (i) frequency of product changes (ii) the number and cost of failed new products and (iii) the extent of entry and exit over time. This logic is in line with a recent OECD working paper[39] on excessive pricing which notes the following:

> *"Determining the magnitude of the profit margin requires an assessment of the true underlying costs incurred by the dominant company. High profit margins might be, for instance, the reward for taking risks and for innovating…In many industries there are substantial risks involved in developing products before they reach the market. Indeed there may be several unsuccessful products developed for each product that is successfully bought to market. <u>These risks</u>*

[38] For example, this would apply in the pharmaceutical industry when new drugs are developed.
[39] OECD. (2011). "Policy Roundtable, Excessive Prices", p 318.

should be taken into account when assessing the costs and profit margin."[Emphasis added]

Conversely, markets that experience little or no innovation and consist of products that have been developed in the distant past should have a lower tolerance level when performing the reasonableness assessment. This logic was outlined in the *Napp* decision where it was noted that the product in question (MST) was formulated many year prior and therefore its price could not be motivated by the cost of innovation:[40]

> *"One of the principal purposes of the patent system is to confer a degree of exclusivity, thus enabling companies to recover substantial research and development costs and investment in new medicines….*
>
> *In the present case, it is now 20 years since the launch of MST, and Napp's formulation patent expired 10 years ago. We do not accept that, after such a long period, the price of MST can credibly be defended on a 'portfolio pricing' theory."*

Existence of cost advantages or inefficiency

The *Mittal* judgment, suggests that it would be appropriate to adjust for a firm's special cost advantages when calculating economic cost. The *Mittal* judgment provides some, yet limited, guidance as to the type of cost advantages one may consider special and how this should be dealt with:[41]

> *"It would seem sound, when considering whether the higher price bears a reasonable relation to economic value or not, to take into account the benefits flowing to the firm from the subsidised loan, long-term low rental, or other special advantage which may serve to reduce its own long-run average costs below the notional norm"*

For example, if a special cost advantage arose because a given firm was buying a key input at well below the known market price then it would seem appropriate to adjust the price of this input price to a market price (where the market prices is higher) in order to reflect economic costs. Therefore any firm specific cost benefits should be incorporated in the economic value calculation and thus can impact the reasonableness assessment to a degree.

[40] Case 1001/1/1/01, Napp Pharmaceuticals Holdings Ltd and Subsidiaries v Director General of Fair Trading, CAT [2002], para 416 – 417.
[41] Competition Appeal Court of South Africa, Mittal Steel South Africa Ltd vs Harmony Gold Mining Company, Case 70/CAC/Apr07, paragraph 43.

Adjusting the dominant firm's costs upwards when special cost advantages are present implies that a higher tolerance level is applicable in the reasonableness assessment for firms with special cost advantages, that is, a higher tolerance level is applied when special cost advantages are acknowledged by the competition authority but have not been taken into account in the calculation of economic value.

Following the same logic, if a dominant firm has any cost inefficiencies then the relevant accounting costs should be adjusted downward for the proper determination of economic costs. This implies that a lower tolerance level will apply when inefficiencies are present but the competition authorities use the firm's actual accounting costs in its analysis. This follows from the *Mittal* judgment:[42]

> *"By parity of reasoning, accounting costs may reflect an uncompetitive inefficiency. The criterion of economic value, on the other hand, recognises only the costs that would be recovered in long-run competitive equilibrium".*

Operational leverage

The extent to which a dominant firm's costs are fixed versus variable should also influence the magnitude of the tolerance level. When the majority of a firm's costs are variable, economic costs are easier to calculate on a per unit basis than when the largest proportion of costs are fixed. In other words, it is easier to assign the variable costs to a product when calculating its economic value.

Cost allocation is made difficult when a firm produces a variety of products lines, which all share the same fixed costs. This difficulty was recognised by Motta and de Streel (2008):[43]

> *"…the threshold price and the 'reasonable' margin over costs would be to a large extent arbitrary, and it is not clear how it should be fixed. Although the Court may have indicated in particular cases that a certain margin was reasonable and another was not, this should not be taken as a rule which holds across sectors. For instance, <u>in sectors where fixed costs are very important relative to variable costs of production, one could not apply the same threshold margins as in sectors where the burden of costs falls upon variable ones</u>"* [Emphasis added]

[42] *ibid*
[43] Motta, M. & de Streel, A. (2008). "Excessive Pricing in Competition Law: Never say Never".

Where fixed costs constitute a greater proportion of total costs (i.e. the dominant firm is highly operationally levered), the dominant firm may be benefiting from economies of scale. For example, a long-standing pay TV provider will be purchasing channel packages at a fixed fee irrespective of the number of its subscribers. In this situation, having a large and growing subscriber base will result in the calculation of a low economic cost per subscriber relative to new start-up pay TV operator.

Therefore, a higher tolerance level should apply for the reasonableness assessment when dealing with firms that are highly operationally levered, and with firms that produces multiple products from the same cost base.

Period of assessment

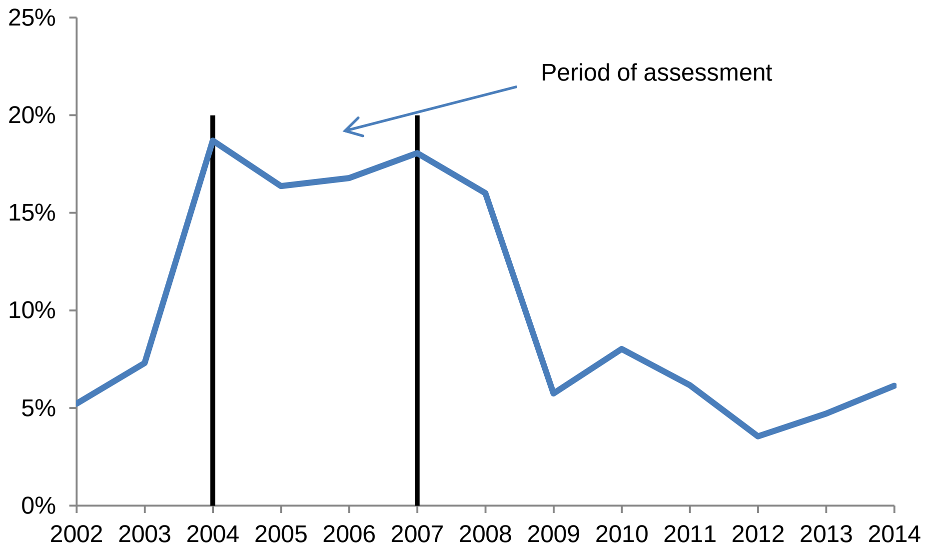
A higher tolerance level is required for alleged abuses covering a short period as economic cycles invariably create variances between prices and economic value. According to an OFT paper dealing with the calculation of economic profits[44]:

> *"The robustness of the results is influenced by the length of the period considered, with a rule of thumb that the longer the period, the better….taking a longer period provides insight into whether the estimated profit levels are persistent"*

For example, if one assumes an operating profit margin higher than 15% to be excessive in the steel industry, global steel producers would have been at risk if profits were assessed for the period 2004 to 2007 only (see Figure 1 below). This short time period ignores the significantly lower margins achieved before and after the alleged abuse period.

[44] The Office of Fair Trading. 2003. Assessing Profitability in Competition Policy Analysis, *Economic Discussion Paper 6*, p. 124.

Figure 1: Global carbon steel profit margins



Source: ArcelorMittal South Africa

Therefore a higher tolerance level should be applied when investigating excessive pricing allegations over a short time period, especially in commodity markets where output prices vary significantly throughout the business cycle.

Existence of intangible assets

A firm with a high proportion of unreported intangible assets is highly vulnerable to excessive pricing prosecution if the value of these assets is not considered when calculating the economic value of its products. In these markets, prices will substantially exceed the unit cost of production as firms have to be compensated for the up-front investments made to develop the intangible asset.[45] For example, a high-end designer handbag manufacturer would have incurred significant up-front marketing costs in developing its brand and, therefore, can charge relatively high prices. Here, the value of the product is not necessarily based on the unit cost of production but rather the uncapitalised marketing costs incurred over many years.

We note the entry of so-called "demand side" factors into the assessment of economic value in cases such as *Port of Helsingborg*. We believe that this was an attempt to escape the straight jacket of calculating observable cost in order to deal with "intangible" benefits derived by customers. In that case, the court held that:[46]

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[45] Bishop, S. and Walker, M. 2002. *The Economics of EC Competition Law 3rd Edition*, Sweet and Maxwell Publishers, p. 238.
[46] Commission of the European Communities, Scandlines Sverige AB vs. Port of Helsingborg, Case COMP/A.36.568/D3, para. 241.

> *"[T]he economic value of the product/service should also reflect the demand side features of this product/service (i.e. the valuation by the customers and consumers of the product/service). Scandlines acknowledges that the port of Helsingborg represents a value to Scandlines and its customers because of its unique location close to Elsinore. The Commission takes the view that this should be taken into account in the assessment of the economic value of the service provided by HHAB and in its price"* [Emphasis added]

Including the contribution of intangible assets to the unit cost of a good/service (e.g. the value of a customer base, brand name or a perceived demand-side value) is problematic as these assets are often not recorded on the balance sheet. The estimation is further complicated by the need to determine the most appropriate amortisation of these intangible assets. Exclusion of this amortisation would result in an under estimation of the economic value. One potential way to overcome this problem is to apply a higher tolerance level for firms that have a high proportion of intangible assets. Where economic value is calculated using reported assets only, it is particularly important that sufficient flexibility is given to the tolerance level assessment.

Convergence of indicators

As previously outlined, there are a number of acceptable approaches for comparing prices to economic value. However the use of a single approach will rarely produce robust conclusions as there are often limitations to the type and depth of data available. In addition, significant information asymmetries exist between the competition authority and the investigated firm. Accordingly, the use of multiple approaches is supported by competition courts and is in line with the preponderance of evidence approach. The OFT guidelines state[47]:

> *"To demonstrate that excessive prices had been set, several indicators would usually be considered…..It is unlikely that a dominant undertaking would be found to have charged excessive prices solely on the basis of supra-normal profitability".*

Furthermore in Napp, the CAT stated:[48]

[47] Office of Fair Trading (2004), pars. 2.8 and 2.15.
[48] NAPP vs. Director General of Fair Trading (2002) at para. 397.

> *"in our view those [price and margin] comparisons, taken together, amply support the Director's conclusions that Napp prices […] were […] well above what would have been expected in competitive conditions"*

As shown earlier, comparing results from different approaches (price-cost to profitability tests) can produce ambiguous results which would suggest that key elements (i.e. intangibles, firm specific cost advantages) were not incorporated in the calculation of economic value. Ambiguity creates uncertainty as to the accuracy of the results and as to whether the respondent priced excessively. Motta and de Streel (2008) argue that:

> *"[Antitrust authorities] should not limit themselves to a mere comparison between prices or prices and costs, but should instead complement it with a deep investigation of the market and of the reasons why prices may diverge or be considerably above the competitive level. <u>In any case, authorities should drop the case if different tests provide different results or if the price does not deviate significantly from the different used benchmarks</u>."*[49] [Emphasis added]

The tolerance level should, therefore, be significantly higher when there is ambiguity in the results so as to minimise the probability of type I errors.

Contentiousness of analysis

The probability of producing divergent results across multiple tests increases the onus of proof on competition authorities. Their task is further complicated by significant disagreements that often occur between the parties on the validity of the analysis. These include criticism around the assumptions used (especially in the cost allocation exercise), the existence of special costs advantages and the use of unverifiable third party information.

Irrespective of the difficulties posed by an excessive pricing investigation, the burden of proof rests with the competition authorities. The findings and recommendations must be able to withstand criticisms raised by the parties. The EC argued in support of the onus of proof in the *Port of Helsingborg*:[50]

> *"The ECJ stated in United Brands that "however unreliable the particulars supplied by [the dominant company]…, the fact remains that it is for the Commission to prove that [the dominant company] charged unfair prices". In that particular case, the court found that <u>the basis for the calculation adopted</u>*

[49] Motta and de Streel (2008), p.38.
[50] Commission of the European Communities, Scandlines Sverige AB vs. Port of Helsingborg, Case COMP/A.36.568/D3, para. 244.

> *by the Commission was open to criticism, and that any doubt must benefit the alleged infringer.*" [Emphasis added]

Any doubt surrounding the final findings must benefit the firm being investigated, and this benefit can be passed on by increasing the tolerance level for reasonableness when comparing price to economic value.

V. CONCLUSION

There currently exists significant uncertainty around the tolerance level allowed between prices and economic value (i.e. a reasonable relationship). In this paper we outline the merits of a minimum tolerance level that should apply to all firms subject to excessive pricing investigations. Intuitively, given the mark-ups implicit in project specific hurdle rates used by firms and the judgments of European excessive pricing cases, a tolerance level of at least 10 per cent over the calculated economic value would be appropriate. A higher minimum can be justified given that the tolerance allowed by the ECJ with regards to excessive pricing remains unclear.

We argue that one prescribed tolerance level should not apply to all cases, and that the level should depend on a number of factors, such as:

(a) *Market dynamism*: A market characterised by frequent product changes require greater compensation for firms for the substantial risk taken on for the development of each product.

(b) *Cost advantages*: Firm-specific special cost advantages should be considered. If these advantages are not included in the calculation of economic value, firms should be offered the benefit of a higher tolerance level when assessing reasonableness.

(c) *Operational leverage*: The difficulties that arise from accurately allocating costs for firms with high operational leverage warrant the tolerance for reasonableness to increase.

(d) *Period of assessment*: If the alleged excessive pricing occurred over a short period of time a higher tolerance level should be considered to allow for commodity cycles or the recoupment of large upfront investments.

(e) *Intangible assets*: A higher tolerance needs to be applied when the firm has a high proportion of assets that are intangible and unreported.

(f) *Convergence of analysis*: Any divergence in the results from comparing price with calculated economic value using different approaches should be privy to a higher tolerance level.

(g) *Contentiousness of analysis*: The burden of proof rests with the competition authorities under Section 8(a). If there is any doubt surrounding the appropriateness of assumptions or techniques used, a higher tolerance level should be applied.

The intention of this paper is not to cover all the possible factors that could affect the determination of reasonableness but rather to initiate the debate. Clarifying the relevant factors through case precedent is a long road, therefore it would be constructive for the Commission to provide written guidance on the minimum tolerance over calculated economic value it would be willing to accept and the factors it believes relevant for extending the tolerance beyond this level.