EXPERT REPORT SG

EXCESSIVE PRICING AS ABUSE OF DOMINANT POSITION

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Article 82 (ex Article 86) of the European Community Treaty of 1957 condemns any abuse by one or more business entities of a dominant position. The first example provided of such abuse is "directly or indirectly imposing unfair purchasing or selling prices."[1] The European Court of Justice has stated that the imposition of unfair purchasing or selling prices lies "inter alia, in the imposition of a price which is excessive in relation to the economic value of the service provided and which has the effect of curbing parallel imports by neutralizing the possibly more favorable level of prices applying in other sales areas."[2] The question of abuse of dominant position, according to the ECJ, must be "considered in the light of all the factors which gave rise" to the claim of abuse.[3] The ECJ in *General Motors* concluded that there was no abuse because the company instituted its pricing scheme in order to meet new regulatory obligations and that soon after the new regulation was imposed "brought its rates into line *with the real economic cost of the operation*." [4]

The *General Motors* decision defined excessive pricing in relation to "economic value" of the product or service. Subsequent decisions have defined "economic value" according to two different approaches. The first approach is based on a consideration of cost structure. The second based on comparative price data.

Cost Based Definitions of Excessive Pricing

In *United Brands,*[5] the ECJ was confronted with the issue of differential and excessive pricing practices in the sale of bananas in the European Community. While the Competition Commission had found that *United Brands* had charged excessive prices, the ECJ overruled the Commission on the excessive pricing issue but found abuse of dominant position on other theories. In overruling the Commission, the ECJ provided an oft cited standard for analyzing excessive pricing cases.

The ECJ noted that the prices charged by United Brands for comparable bananas were up to 100 per cent greater in Denmark, the Netherlands, and Germany than in Ireland, resulting in "a substantial and excessive profit in relation to the economic value of the product supplied."[6] The Court also noted that there was up a twenty to forty per cent

[1] See Article 82 (a).
[2] See General Motors Continental, 1975 ECJ CELEX LEXIS 2551 ¶ 12.
[3] See General Motors ¶ 15.
[4] See General Motors ¶ 21-22 (emphasis added).
[5] 1978 ECJ CELEX LEXIS 2999.
[6] See United Brands ¶ 239.

difference in price between branded bananas sold by United Brands and similar, unbranded bananas.[7] However, these discrepancies were not sufficient to establish excessive pricing absent a consideration of United Brands' cost structure. The Court concluded that the Commission failed to establish excessive pricing because it was "under a duty to require [United Brands] to produce particulars of all the constituent elements of its production costs."[8] Since the Commission had failed to consider costs, the excessive pricing claim was dismissed.

The ECJ provides an important set of guidelines to aid in establishing a claim of excessive pricing as abuse of dominant position:

> 251. This excess could, inter alia, be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its cost of production, which would disclose the amount of the profit margin;....
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> 252. 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.
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> 253. Other ways may be devised–and economic theorists have not failed to think up several–of selecting the rules for determining whether the price of a product is unfair.[9]

The ECJ proposes a two part test for determining whether a company has abused its dominant position by imposing an excessive price. First, there must be an excessive profit margin as measured by the difference between price and the costs of production. Second, this profit margin must be unfair either in isolation or in comparison with prices of competing products. The Court states that this is only one rule to be used in determining excessive pricing, leaving open the possibility that other rules can be devised based upon economic theory.

Several complicating factors arise in determining a company's cost structure. The Court lists the following: discretionary apportionment of indirect costs and general expenditure, size of the undertaking, the company's object, the complex nature of the company's setup, the company's territorial area of operations, product scope, and the number of subsidiaries.[10] The Court concludes without analysis that the determination of United Brands' production costs did not "present any insuperable problems."[11] The discussion leaves open the possibility that the analysis would be different if there were "insuperable problems."

The *United Brands* opinion has been quite influential. For example, in *British Leyland* PLC,[12] the ECJ, relying on *United Brands*, concluded that differential fees for left handed cars were "fixed at a level which was clearly disproportionate to the economic value of the service provided and that the practice constituted an abuse by BL of the monopoly it

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[7] See United Brands ¶ 240.
[8] See United Brands ¶ 256.
[9] See United Brands ¶¶ 251-253.
[10] See United Brands ¶ 254.
[11] Id.
[12] Case 226/84, 1986 ECR 3263.

held by virtue of the British rules."[13] The *United Brands* opinion also served as a basis for two important settlements between the Competition Commission and telecommunications firms in which an excessive price was replaced with a price based on a reasonable profit markup on cost.[14]

Price Comparison Definitions of Excessive Pricing

In *Tournier*,[15] the Court reviewed the Commission's finding that SACEM, the European organization that licenses performance rights, abused its dominant position by charging excessive prices for music royalties. The Court concluded that *United Brands* was not applicable "because it is impossible to determine the cost of the creation of a work of the imagination such as a musical work.....and to compare the level of the royalties charged by SACEM with that of competitors because there are none."[16] Nonetheless, the Court found that the royalties were excessive based upon a price comparison approach.

Given the inappropriateness of the *United Brands* approach, the Court provided an alternative, objective standard. The Court offered an objective method to determine excessiveness "consisting in a comparison between the level of the royalty (taking account for this purpose of the total revenue generated by the royalty) on the one hand, and the necessary costs of the effective management of performing rights and the need to ensure reasonable remuneration of the copyright owners on the other hand."[17]

Disproportionateness of the royalty is to be determined "(a) in relation to the royalties imposed by the same society on other categories of customers; (b) in relation to the necessary costs of the effective management of copyright and to the need to ensure reasonable remuneration for copyright owners."[18] After examination of SACEM's treatment of different categories of customers and of its costs of management, the Court concluded that the royalties were in fact excessive. In a related case involving SACEM, which was decided jointly with *Tournier*, the ECJ stated that SACEM imposed "unfair trading conditions where the royalties which it charges to discotheques are appreciably higher than those charged in other Member States, the rates being made on a consistent basis."[19]

The *Tournier/Lucazeau* cases present an oft cited approach to excessive pricing based on price comparisons among sales of comparable goods incomparable markets. The approach has been applied in several contexts. In *Bodson*,[20] the Court concluded that excessive pricing in funeral services could be established by comparing prices of funeral services across geographic markets in which funeral services are unregulated.[21] Similar approaches have been adopted in excessive pricing cases involving automobile spare parts[22], phonorecords[23], and cosmetics.[24]

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[13] See British Leyland ¶ 30.
[14] See ITT Promedia/Belgacom, Twenty-seventh Report on Competition Policy, point 67, and Deutsche Telekom, Twenty-seventh Report on Competition Policy, points 76-78.
[15] 4 C.M.L.R. 248.
[16] See Tournier at 271.
[17] Id. at 276.
[18] Id. at 278.
[19] Lucazeau, 1989 ECJ CELEX LEXIS 6255 ¶ 33.
[20] 1988 ECJ CELEX LEXIS 7108.
[21] Id. at 7132.
[22] See Renault 1988 ECR 6039 and Volvo/Veng, 1988 ECR 6211.
[23] See Deutsche Grammophon, 1971 ECR 487.

Two Important Cases from the United Kingdom

The United Kingdom established important precedent for excessive pricing in the very first action brought by the Office of Fair Trading under the UK Competition Act of 1998. In *Director General of Fair Trading v. Napp Pharmaceutical Holdings Limited*, a British pharmaceutical company was fined 3.21 million pounds for excessive and predatory pricing. The test for excessive pricing applied by the Director General, and affirmed by the Competition Commission, consisted of a two-stage inquiry. First, the Office will consider whether prices are higher than would be expected in a competitive market. Second, the Office will consider whether there are substantial barriers to entry which would limit competitive pressure to bring the prices down to competitive levels. The UK approach focuses not solely on cost structure or on price comparisons, but on competitive pressures and barriers to entry.

The importance of UK competitive law in defining excessive pricing is further exemplified by a recent OFT decision against a pharmaceutical company. In March, 2003, Genzyme, a U.S. company was recently fined by the Office of Fair Trading in Britain. for exclusionary pricing of an enzyme treatment to the National Health Service. According to one article:

> The OFT found that Genzyme had abused its dominant position in breach of Chapter II of the 1998 Act by charging the NHS a price for Cerezyme which included home delivery and the provision of homecare services and adopting a pricing policy that allowed no possible margin.
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> It also found that Genzyme's behaviour prevented competition in the home delivery of Cerezyme, deprived the NHS and patients of a choice of delivery and homecare services providers, and raised barriers to entry in the market for the supply of drugs for the treatment of Gaucher by preventing viable independent provision of delivery and homecare services for Cerezyme.

The OFT has indicated that Genzyme should end its exclusionary pricing behaviour (or measures having an equivalent effect), offer to supply Cerezyme to the NHS at a stand_alone price, and supply Cerezyme to third parties at a price no higher than the stand_alone price. Genzyme has two months to appeal the decision and/or the level of the financial penalty to the Competition Appeal Tribunal.[25]

The decision of the UK Office of Fair Trading was based on two legal violations by Genzyme: the creation of a tie-in arrangement and a margin squeeze.[26] The second is relevant to our discussion of excessive pricing. A margin squeeze occurs when a firm "operates a pricing policy which does not allow reasonably efficient competitors in the downstream market a margin sufficient to enable them to survive in the long term."[27] This

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[24] See Sirena, 1971 ECR 69.
[25] See Clifford Chance, Abuse of Dominant Position, PLC Magazine (May 1, 2003). The fine is currently under appeal to the Competition Appeal Tribunal.
[26] Decision of Director General of Fair Trading, No. CA98/3/03, Exclusionary Behaviour by Genzyme Limited, 27 March 2003 (Case CP/0488-01) ¶ ¶ 295, 364.
[27] Id. at ¶ 364.

cause of action is similar to what in the United States is called "predatory pricing." In the case of Genzyme, its dominance in the production of the drug Cerezyme, used to treat Gaucher's disease, allowed it to tie in delivery of home care services and squeeze the profit margins for other providers of home delivery services.[28]

The Office gauged this squeeze in two ways. First, it asked whether Genzyme could compete if it were faced with the same entry and cost conditions as its competitors. In other words, Genzyme was able to cross-subsidize its home care delivery services with the profits from the sale of the drug Cerezyme.[29] Alternatively, the Office compared the cost structure of Genzyme and a competitor and found that Genzyme charged the competitor the same price for the drug as it charged the National Health Service for a drug and home delivery service. Consequently, the competitor had no margin on which to compete with Genzyme in the distribution of the drug.[30] The Office develops a useful approach to gauging predatory behavior by a dominant player based on pricing behavior.

General Points from the European Community Case Law

Excessive pricing under European Community law requires a showing of discrepancy between the price and the economic value of the product and service. This discrepancy can be established either through a comparison of price and costs or through a comparison of prices for comparable products across comparable markets. The competition law of the United Kingdom provides an approach that considers barriers to entry and the formation of a competitive market. Several lessons can be drawn from this body of law.

The first lesson is about drawing quantitative guidelines for determining excessive pricing. One article provides a helpful summary of what price markups have been deemed excessive. In *General Motors*, price that was up to 400 times actual costs was disapproved while a price that was eight times effective costs was acceptable. In *United Brands*, profits margins up to and over 100 per cent were disapproved while price decreases of fifteen per cent were found to be satisfactory. Similarly, in *British Leyland*, margins of 100 per cent were disapproved. In *ITT/Belgacom*, price markdowns of 90 per cent were deemed satisfactory when price differentials were estimated to be at 900 per cent; in *Deutsche Telecom*, markdowns of 38 per cent to 78 per cent were deemed acceptable to remove price differentials of 100 per cent.[31]

The second lesson is the role of competition law in policing excessive pricing of essential goods and services. While, in some of the excessive pricing cases, the goods and services can be classified as luxury items, such as the cards in *British Leyland* or the discotheques in *Tournier*, many of the cases involve goods that are essential or vital to consumer needs. Fruits and other foods in *United Brands* provide one example of essential products whose pricing has obtained special scrutiny. Telecommunications and funeral services provide other examples.

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[28] Id. at ¶¶ 371-373.
[29] Id. at ¶ 375.
[30] Id. at ¶¶ 376-377.
[31] See Erik Pijnacker Hordijk, "Excessive Pricing under EC Competition Law; An Update in Light of 'Dutch Developments,'" in Barry Hawk (ed.), 2001 Annual Proceedings of the Fordham Corporate Law Institute: International Antitrust Law & Policy (2002).

Excessive pricing and the policing of the market for essential goods and services relate to the third lesson from the EU and UK case law: the importance of the cases in protecting consumer interests. The reliance on cost structure as a gauge on pricing reflects the normative underpinning of consumer sovereignty in competition law. The goal of the law is to provide a product and service to as many consumers as possible at the lowest price. The model of perfect competition that serves as the baseline for both EU and UK law is an economic ideal precisely because perfect competition allows for the maximization of consumer surplus.

Similarly, the reliance on comparative price data in cases like *Tournier* also reflect the norm of consumer sovereignty. Regulating excessive pricing through comparative price information provides a means of limiting price discrimination and the imposition of a uniform and low price in the relevant market. The difficulty is that, in some instances, price discrimination may enhance consumer sovereignty, especially if it allows firms to service low demand consumers by cross subsidies from high demand consumers. Consequently, the EU has adopted a nuanced approach to gauging excessive pricing based on price differences. As demonstrated in the *Tournier* case, price differences need to be analyzed in terms of the relevant customer base. The *Bodson* case provides another useful example of the importance of consumer interests in analyzing excessive pricing. The court's analysis entailed a very detailed look at the funeral industry and the needs of consumers in gauging the excessiveness of the price. Consumer interests are the baseline from which excessiveness is determined, and consumer sovereignty is the norm.