Excessive Prices

Back to the future?

Presenter name here (edit on master)
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Charles River Associates

1. Excessive prices – old school style…

How does one test for an excessive price?

United Brands two stage test (confirmed in *Port of Helsingborg*):

- Whether the difference between the costs actually incurred and the price actually charged is excessive. (Para 147, 149)

- Whether a price has been imposed which is either unfair in itself or compared to the price of competing products.

Stage one – Excessive price-cost margin?

What difference between price and cost is excessive?

- Can't be any difference as all dominant firms would be guilty of excessive pricing (see para 142 *United Brands*).
- Is excessive a relative concept to market structure? i.e. different in a duopoly than with 10 players – or is excessive an absolute concept?

What is cost?

- Marginal costs?
- Long run average cost?
- How do you allocate joint or fixed costs (*Ramsey-Boiteux* pricing)?
- What about dynamic costs?

What price?

- Price to an individual consumer? What about cross subsidisation?
- Price across a number of products – if they are related?
- Average price on the relevant market?

Stage two – Fair price relative to others

Use of other comparators as a guide to 'unfair' pricing:

- Which comparators?

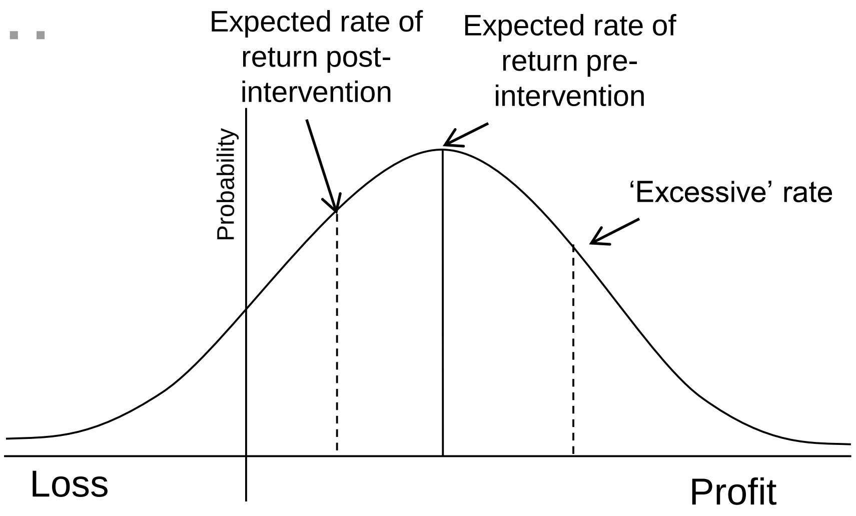
Cost differences?

- Need to model differences in costs between benchmarks.
- Costs as a function of quantity provided? Endogeneity?

'Economic' value and demand differences?

- If one country is higher demand, or is more demand inelastic – should this be factored in (*Port of Helsingborg*)?
- Price discrimination is often optimal in that it allows firms to expand the market by allocating fixed costs efficiently.

Cost of getting it wrong…



Excessive pricing cases can harm innovation/investment:

- Investments often involves risks that will not succeed.
- For a company to be successful need to be able be able to cover these risks.
- Suppose whenever they had a hit product you applied excessive price case to lower price?
- Result would be to lower overall expected return on investment.

Therefore would be willing to invest less to achieve lower expected return.

Pharmaceutical industry:

- Only 1 in 10 drugs at pre-clinical trials makes it to market.
- Estimated in 2003 it cost $800m to bring a successful drug to market.
- Highly skewed success, top 10% drugs realise 50% of revenues, 80% of drugs don't cover costs.

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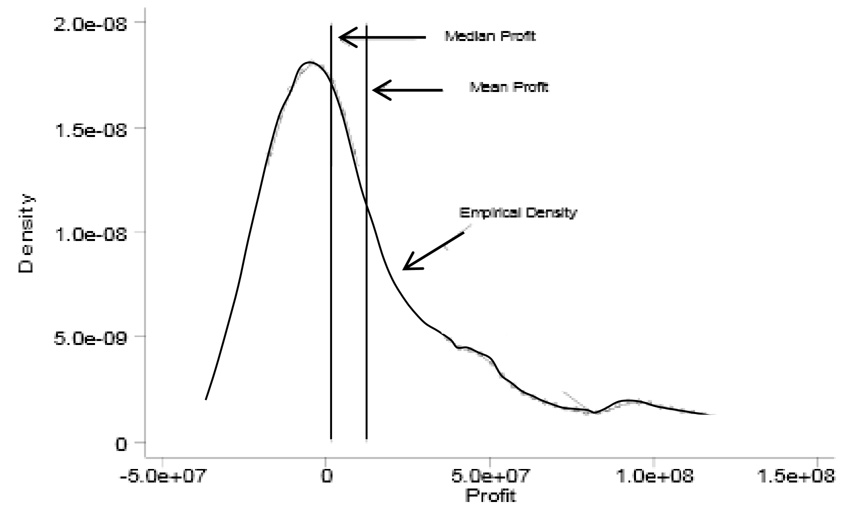

Note: The empirical density function plotted above was estimated using the Epanechnikov kernel.

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Film industry:

- "The distribution of returns is skewed – it is composed of many films that flop, and some that are phenomenal hits" *Handbook of Movie Economics*
- De Vany and Walls (2004b) analyse movies 1984-1996, find 78% were unprofitable; Vogel (1990) reports 80% of all movies are unprofitable.

And if you get it right…

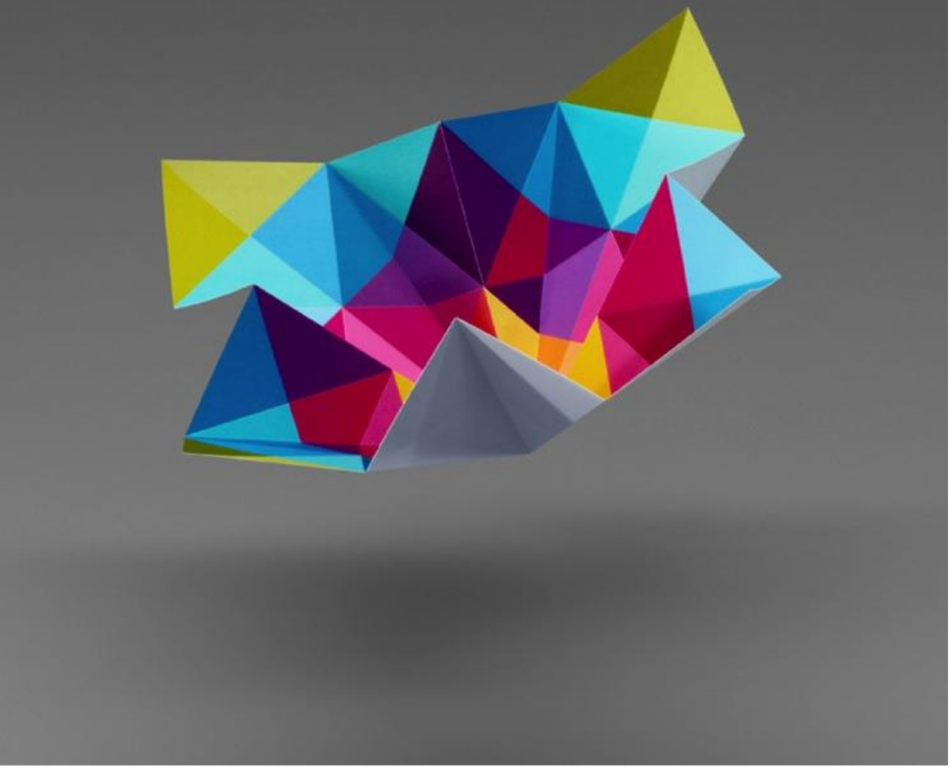
Remedy risks regulation:

- Defining what price is excessive very quickly brings you to defining what is the maximum non-excessive price.
- Even if escape this, remedy only really involves price – no ‘behaviour’ which party can stop.

Excessive pricing only in exceptional circumstances?

- Constructive refusal to supply and excessive pricing have much in common.
- Should there be a similar set of exceptional criteria?

3. New school…



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The Future is the Past? SEP Cases

Theory of harm:

- Firms holding SEP can charge an ‘excessive’ rate to firms
- Excessive rate is equal to the monopoly rate plus a ‘hold-up’ rate proportional to the cost that implementer would have to invest in order to delay implementation and invent around SEP.

Constructive refusal to supply or excessive pricing case?

Even more problematic than traditional cases?

- Taking cases in precisely the ‘dynamic investment’ industries where getting it wrong is so costly.
- Presumption of patent dominance rather than analysis of dominance?
- What is the remedy? Will competition authority stipulate the FRAND rate where courts have generally feared to tread?!
- What will happen when SEP patents ½ in value?

Conclusions

Excessive pricing cases are very difficult:

- Asks difficult questions regarding price and costs.
- Very cost

If excessive pricing case is not difficult – you are probably not doing it right!

Look for the root causes of the high prices not the high price symptom

- Look for structural elements that are causing high prices rather than tackling high prices themselves.
- Barriers to entry? Agreements that restrict competition?

If you do take an excessive price case, it should only be in 'exceptional circumstances' – don't create general precedence that reduces incentives to make investments in potentially high risk (high return) products.

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