CRA Competition Memo

Excessive Pricing Disharmony

A recent South African case provides some important lessons on the prosecution of alleged excessive pricing. In September 2002 Harmony, a South African gold producer, complained to the South African Competition Commission that Mittal Steel was setting excessive prices for flat carbon steel sold in South Africa.[1] During the relevant period, South Africa was a net exporter of flat steel products, and Mittal accounted for more than 80% of domestic production. The price that Mittal realised on exports equalled the price in the destination markets less transportation costs from South Africa ("export parity"). For sales in South Africa, however, Mittal set its prices on the basis of "import parity", i.e. the price at which imports could be brought into South Africa. As a result of the large transport costs between South Africa and the major steel markets, the export parity price was on average about 40% below the import parity price.[2]

The case was first considered by the South African Competition Commission. In January 2004 it decided to drop the case and not to refer it to the Competition Tribunal (the "Tribunal"). Harmony appealed this decision and the Tribunal agreed to look at the case. After an extensive trial in 2006 lasting more than a month, the Tribunal found Mittal guilty of excessive pricing in a decision published in March 2007. Six months later the Tribunal fined Mittal a record fine of nearly R700m (approximately $100m at the time) and imposed further remedies. Mittal appealed against the Tribunal's judgement and in May 2009 the Competition Appeal Court (CAC) overturned the Tribunal's judgment in full.

There are not many excessive pricing cases in the case law, either in South Africa or in Europe, and this case raised a number of very interesting issues. In this memo we discuss just two of these. First, this case highlights the fact that excessive pricing cases require difficult empirical analysis that competition authorities cannot avoid. As we discuss below, the Tribunal tried to avoid such analysis and was roundly condemned by the CAC for so doing. Second, and related, it illustrates the dangers of taking a purely structural approach to questions of dominance and abuse.

The basic arguments of the parties

Harmony argued that import parity pricing was abusive when carried out by a firm that exported a significant proportion of its output, as Mittal did. Harmony argued that Mittal's effective export price (i.e. its factory gate price for exports) should be considered as the competitive price and so Mittal's domestic price, which was above this level, should be considered excessive. Harmony's case was therefore based on comparisons between different prices for product that was physically similar.

Mittal took a different approach.[3] It argued that a firm that was pricing excessively and that was not inefficient should be earning excessive profits. Mittal presented evidence that over the period 2000-6 it failed even to earn its cost of capital, let alone make excessive profits. Mittal also presented evidence showing that its domestic South African prices were similar to domestic prices in other parts of the world. So Mittal's defence was based on profitability analysis and international price comparisons.

The Tribunal's decision

The Tribunal took a different, but very interesting, approach to the question of excessive pricing. It took the view that it was not a price regulator and that the standard approach to excessive pricing in the European case law was essentially a regulatory approach. By this it meant that excessive pricing cases have traditionally involved the sort of analysis that regulators often carry out (e.g. profitability analysis, calculation of the cost of capital and so on), followed by some form of price regulation where excessive prices are found. The Tribunal chose an approach that it hoped would avoid these difficulties.

The Tribunal concluded that the relevant market was the South African market for flat steel and that Mittal was therefore not just dominant, but was super-dominant. The Tribunal further concluded that barriers to entry were very high and that there was no prospect of new entry even in response to excessive pricing. The Tribunal concluded that Mittal must be pricing excessively since a super-dominant firm facing no prospect of new entry would naturally exercise its substantial market power by raising prices towards the monopoly level. As evidence that Mittal was exercising market power, the Tribunal cited the fact that Mittal offered discounts to some industries, such as the car manufacturing industry, that had buyer power but not to other industries that did not have buyer power. The Tribunal quite explicitly did not base its decision on profitability analysis or price comparisons. At paragraph 142 of its decision the Tribunal stated that

> "the judgement then that we are required to make is not of the price level itself but rather of the market conditions that generated the price level. In other words, we must ask ourselves whether the relevant market in question is capable of functioning in a manner that is likely to produce a reasonable

[1] At the time of the original complaint, Harmony complained about Iscor's behaviour. Iscor was subsequently bought by Mittal, which has subsequently merged with Arcelor. Throughout this note we refer simply to Mittal.

[2] This figure relates to the period from January 2001 to June 2005.

[3] Mike Walker was Mittal's economic expert.

relationship of price to economic value".

Though this approach is interesting, there are at least two fatal objections to it and it was no surprise that the CAC upheld the appeal.

Excessive pricing cases require a benchmark

Whether or not a firm is pricing excessively is a question about the level of the price. It is not a question about the price formation process. In order to evaluate whether a price is at an excessive level, it is necessary to have a benchmark "non-excessive" price to which the alleged excessive price can be compared. There are two parts to the estimation of the non-excessive price. First, what is the competitive price level i.e. the price that would prevail under conditions of effective competition? Second, at what point above the competitive price level do prices become excessive?

The standard approach to excessive pricing is to use profitability analysis and price comparisons. The Tribunal refused to engage in any price comparisons or in any profitability analysis. The result was that Mittal was put in the position of being found guilty of excessive pricing without knowing what the non-excessive price was. As the CAC put it:

> "The erroneous approach of the Competition Tribunal also explains why Mittal ends up in the anomalous and wholly impractical position of having been found guilty of and heavily fined for excessive pricing, without any finding of which prices for which of the variety of products were excessive, nor of the period in which the excessive prices were charged, nor of what a non-excessive price would have been, nor of the amount of the excess which it was found to have charged".[4]

There was evidence put to the Tribunal that indicated that over the steel cycle, Mittal was not earning its cost of capital. There was also evidence submitted that Mittal's two plants in South Africa were low cost plants by international standards. If both of these pieces of evidence were correct (and Harmony disputed this), then the Tribunal's decision would mean that an efficient firm that was not earning its cost of capital (i.e. was not making economic profits) was nonetheless found guilty of charging excessive prices. This conclusion would be contrary to any standard notion of excessive pricing, but the Tribunal's approach meant that this was quite possibly the situation that Mittal was in. Only by engaging with the evidence on profitability and price comparisons could the Tribunal have avoided this outcome, but its purely structural approach meant that it did not engage with this evidence. The CAC was clear that an excessive pricing case required the Tribunal to assess price levels, not just structural measures.

An important aspect of the CAC's judgement is that it provides a conceptual framework for the estimation of the competitive price level. This is something that the Tribunal shied away from. The European case law, and the actual law in South Africa, defines an excessive price as one that does not bear a reasonable relationship to "economic value", but nowhere is "economic value" defined. The CAC defined "economic value" as the price that would hold under "conditions of long run competitive equilibrium". This is equal to the long run average cost of an efficient firm, where costs include a fair rate of return. As the CAC noted, this is not the same as perfect competition, but instead implies that competition is strong enough to eliminate economic profits in the long run (although the short run may well be characterised by either economic losses or profits). It should also be noted that the CAC did not find that pricing above the competitive price level was a sufficient condition for excessive pricing, but only that it was a necessary condition.[5] It was, unfortunately, silent on the question of how much above the competitive price level dominant firms are allowed to price.

Measuring dominance is not simple

The Tribunal assumed that Mittal was able to price excessively because it was super-dominant. However, the Tribunal's logic for concluding that Mittal was super-dominant was of necessity circular. In economic terms, a dominant firm is a firm with substantial market power. Market power is the ability to price above the competitive price level. But as noted above, the Tribunal made no attempt to estimate the competitive price and so could not tell directly whether Mittal had market power.

The Tribunal tried to conclude that Mittal was super-dominant through indirect means. It argued that Mittal had more than 80% of the South African flat steel market and so must be dominant. But how did the Tribunal define the relevant market? The standard approach to market definition is the hypothetical monopolist test. In an abuse case this asks whether a hypothetical monopolist of the products in question within a given geographic area could profitably raise prices by 5-10% above the competitive price level. This test cannot be carried out unless you know whether prevailing prices are at the competitive price level or not.[6] So we are back to square one: you need to have some estimate of the competitive price level.

Of course, if the Tribunal had identified the competitive price, then it would not have needed to rely on any deductions based on super-dominance. Instead, it could simply have compared the actual prices charged by Mittal to the competitive price level and, if the former were above the latter, then decided whether the difference between the two was excessive. We accept that this final step would have been a difficult matter of judgement for which the case law and economics provide little guidance, but in our view it would have been an unavoidable step.

Conclusions

We fully sympathise with the wish that the Tribunal had to avoid the difficulties and messiness of an excessive pricing case. However, it is our view that these are not avoidable. The Tribunal's structural approach to excessive pricing, whilst interesting, is not an adequate alternative. By refusing to deal even with the conceptual issues of what constitutes an effectively competitive price and of how far above this prices can be before they become excessive, the Tribunal provided no guidance to dominant firms as to what level of pricing is acceptable.

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4 Paragraph 54 of the CAC decision.

5 This is consistent with the UK Court of Appeal decision in *Attheraces*.

6 This problem is an example of the well-known *Cellophane* fallacy.

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