

Excessive prices – do we care, and how would we know?



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EXCESSIVE PRICING OF INPUTS



- A very common scenario involves the alleged excessive pricing of an INPUT to a downstream competitor of a vertically integrated firm.
- In this case, the natural test is simply the margin squeeze test (whatever that is, but that is another Pros and Cons)
- In foreclosure cases, the firm "overmonopolises" the input - because of the downstream share-shifting effect. In these cases, the profit derived from the input will be below the monopoly profit.

DO WE CARE ABOUT EXCESSIVE PRICES?



- We prosecute cartels and cartelists (even if they fail to achieve full coordination).
- We prohibit mergers to monopoly, duopoly and often triopoly.
- So we happily prosecute OUTCOMES that yield less than the monopoly price.
- The question is - does the PROCESS by which an OUTCOME was achieved affect our thinking?

THE MORALS OF EXCESSIVE PRICES



- We are substantially more tolerant morally of excessive prices than cartels and merger to monopoly EVEN IF THE OUTCOME IS ABSOLUTELY THE SAME.
- It certainly may affect our normative views of desert that someone earned their way to the top by skill, industry, foresight or even luck (if combined with risk taking). But what if they predated or bribed or lobbied their way there?

EFFICIENCY CONSIDERATIONS



- Economically the process matters, for efficiency reasons.
- Cartels - can never lead to good so we ban even if prices do not rise.
- Mergers to monopoly - ban, because we prefer the competitive process of struggle to achieve monopoly.
- Those who fought their way to monopoly likely
 - had to have offered consumers a good deal along the way.
 - cannot have been too inefficient.

High prices and profits

- Reward skill, foresight, industry and risk taking (and luck) and therefore incentivise these things (especially with favourable capital gains tax regimes).
- Act as a beacon to attract (efficient) entrants, both their entrepreneurial talent and their capital.

SUMMARY SO FAR



- For equivalent outcomes (and allocative inefficiency) we are, both morally and economically, appreciably LESS concerned with excessive (monopoly) pricing than cartels or mergers to monopoly.
- An agency engaging in efficient resource allocation equalising social returns at the margin should probably be chasing every cartel it can find, prosecuting most non-de minimis mergers to monopoly, but comparatively few excessive pricing cases.

FIVE SEQUENTIAL CRITERIA



1. Excessive profits as given by return on capital "substantially higher" than the cost of capital calculated by CAPM.

AND

2. Where the profits remain at that level for a "significant" period of time

WHERE

3. The ex-post recorded profits have been adjusted for ex-ante risk and hence attendant survivorship bias.

AND

4. The capital base has been grossed up to include the (risk adjusted) cost of intangibles.

AND (?)

5. The recorded profits are over the project reduced by the "wage cost of entrepreneurship" .

STAGE 1



- **“Excessive profits as given by return on capital ‘substantially higher’ than the cost of capital calculated by CAPM.”**
- So what is substantially higher? Double?
- Let's move on...

- **“Where the profits remain at that level for a ‘significant’ period of time.”**
- At least 5 years?
- Sufficiently so that all investments are amortised and there is no stranding risk? (Dispensing with need to forecast "depreciation" e.g. there would be "no regrets" if the firm went bankrupt at that instant.)

STAGE 3



- **“The ex-post recorded profits have been adjusted for ex-ante risk and hence attendant survivorship bias.”**
- This is very tricky but utterly fundamental.
- If it's too difficult, the appropriate response should be "don't prosecute" not "ignore ex-ante risk".
- Assess:
 - i. Prior economic losses of the accused.
 - ii. Prior economic losses of the accused and any company they acquired.
 - iii. Prior economic losses of any company that operated in the relevant market (relying on free entry as an ex-ante rent dissipation game).
 - iv. Prior economic losses of any company that provided a demand substitute (short of being in the relevant economic market).

STAGE 4



- **“The capital base has been grossed up to include the (risk adjusted) cost of intangibles.”**
- This effectively requires a lifetime assessment of profitability from the beginning of the project.
- If a firm made low economic profits whilst building its brand name, those subnormal profits must be capitalised at the cost of capital (and adjusted for ex-ante risk).
- NB - this is a historical assessment of negative economic profits. This is NOT recommending looking at an estimated current brand value as that simply capitalises the excess return.

STAGE 5



- **“The recorded profits are over the project reduced by the ‘wage cost of entrepreneurship’.”**
- Profits should be after all economic costs.
- The costs of entrepreneurship are taken out ex-post when successful not ex-ante as the effort and risk is injected.
- Subtract from profits the cost of entrepreneurship.
- How to measure? Is entrepreneurship at least as hard and risky as becoming a partner of a major law firm or a director of an investment bank?
- Those professions enjoy (?) £10m of economic rent over a career.
- Ignore small companies, particularly if founder-owned...

OTHER ANTITRUST CASES



- Don't go for excessive pricing when the real complaint is something else.
 - Price discrimination without objective justification (e.g. not output expanding).
 - Bundled prices masking excessive and predatory prices (head in the oven, feet in the fridge).
 - Margin squeeze - excessive pricing of input to foreclose entry.
 - Aftermarket abuse - "surprise" theory of aftermarket power, exploiting customer sunk costs incurred on basis of reasonable expectations.

PRELIMINARY INDICATORS



- Price cost margins
- Benchmarks and yardsticks
- (Discriminatory) prices of same seller
- International price comparisons
- Otherwise competitive benchmarks
- Unbranded products

- Particular attention to significant price HIKES.
- Burden of proof on domco to explain what has changed in its first order condition.
- Often reveals other issues
 - foreclosing intent
 - exploitation of switching costs (flipping from sowing to harvesting)
 - loss of marginal customers (e.g. in declining market)
 - breach of implicit contracts (having induced customer investments)

- Price control is generally close to impossible (outside of a regulated market).
- Excessive prices would normally arise from a failure of the competitive process.
- Criteria similar to those motivating UK market investigations.
 - Tacit coordination (look at responses to demand and cost shocks)
 - Artificial government barriers to entry (and incumbent lobbying)
 - Barriers to entry from (vertical) market structure
 - Bad equilibria
 - Customer information and rationality issues
- These perhaps better tackled directly - leaving excessive pricing only for the "unilateral effects" cases.

CONCLUDING THOUGHTS



1. A pure excessive pricing case is surely a rare animal, if not a unicorn.
2. Many are "really" manifestations of distinct antitrust issues.
3. Many happen in legacy utility-nationalised-privatised industries.
4. Excessive pricing may be a neat device for avoiding well-known loopholes on other issues.
5. So (like treason?) we should keep it on the statute book, but not use it very often.