Excessive Pricing revisited: what is a competitive price?

(Or, how many economists does it take to define economic value?)

PRELIMINARY DRAFT, NOT FOR CITATION OR CIRCULATION

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1. Introduction

Excessive pricing and the assessment thereof has come under the spotlight again with the recent release of the Competition Tribunal decision on the Competition Commission v Sasol Chemical Industries matter (SCI). The case is the first opportunity for competition authorities to test the guidance that was provided by the Competition Appeal Court in the Harmony Gold/Mittal case, where the court attempted to provide clarity on what the legislation means when it refers to economic value. The guidance by the Competition Appeal Court (CAC) in Mittal, on the interpretation of economic value, has been commended as allowing for a 'coherent economic analysis' of excessive pricing, interestingly by the economists who have testified as experts for the defendants in the South African cases (Calcagno and Walker, 2010; Padilla expert witness testimony, p 1792). We revisit the debate on excessive pricing, and explore how the guidance of CAC *Mittal* takes the debate on determining economic value forward when it was 'test driven' in the SCI matter. This includes, in particular, the various interpretations of economic value and their practical application taking into account issues with measuring costs. .

Excessive pricing is arguably the most contentious area of competition enforcement. There are diverse views on the need for intervention by competition authorities (Roberts, 2008; Evans and Padilla, 2005, Motta and De Streel, 2006; Ezrachi and Gilo 2009). Those arguing against intervention are of the view that it is generally unnecessary as prices significantly above a competitive level will ordinarily attract new entry, resulting in competition which will in turn drive prices down (O'Donoghue and Padilla, 2006; Calcagno and Walker, 2010). Other grounds that are often cited for limited or non-intervention are the difficulties in calculating the counterfactual price for the determination of excessiveness and that enforcement of excessive prices may chill investment (Ezrachi and Gilo, 2010). The validity of the non-interventionist approach has been questioned with analyses showing that the self-correction argument may not hold in many real life situations and other grounds should be assessed on a case by case basis (Ezrachi and Gilo, 2010).

The diverse views have resulted in varying approaches by the different jurisdictions, for example, the US does not condemn excessive prices, while the European Commission has adopted a limited intervention approach even though several member states' competition

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authorities are actively pursuing cases. Similarly, the South African Commission has taken on excessive pricing cases.

The divergence in approaches can be partially explained by the nature of the markets in these jurisdictions. The countries' choices regarding excessive pricing reflect decisions about the relative balance between risks of over and under-enforcement in the context of their challenges and conditions. While the US and EU have large markets where it is unlikely for a single firm to be able to act unconstrained by entry, in South Africa and other smaller economies which are faced with overwhelmingly dominant firms and where there are barriers to entry, it is possible for firms to extract high margins from their positions. These smaller markets mean that when there is a need to achieve economies of scale the industries will typically be more concentrated. For example, the scale of production of sugar by Zambia Sugar, producing approximately double domestic demand means that there is only one very large firm and others of similar size are unlikely (Chisanga *et al*, 2014). Similarly, the scale of production required for integrated flat steel production is far above the size not just of demand in South Africa, but of demand in neighbouring economies also. In the case of wheat milling in South Africa scale economies have been found to mean that there can only be a few firms, implying that in smaller markets there may well be unilateral dominance (Grimbeek and Lekezwa, 2013). In such instances the cost of under-enforcement is high, particularly where the relevant product is an intermediary input into other markets. Recognising that the different jurisdictions have different market characteristics, it is then appropriate that there is a divergence of approaches to excessive prices (Evans, 2009).

In recognition of the risks of over enforcement, economists have identified circumstances that may require intervention by competition authorities (O'Donoghue and Padilla, 2006; Motta and de Streel, 2007; Roberts, 2008; Evans, 2009; Lewis, 2011). There has been some debate about the nature of barriers to entry that should be adopted in the limiting principles. The requirement for legal barriers to entry (Evans and Padilla, 2005), would in a literal reading, exclude a number of firms that have entrenched (near) monopoly positions and are not subject to regulation, including Mittal and *SCI*. Lewis (2011) argued that in circumstances where barriers to entry were established by historical circumstances, technological and commercial considerations, the effect is at least as insurmountable as legal barriers. In a similar vein, O'Donoghue and Padilla (2013) move away from the position on legal barriers to argue that intervention should be limited to those industries "*(1) that are protected by high barriers to entry; (2) where one firm enjoys considerable market power; and (3) where investment and innovation play a relatively minor role*". In such markets, the high prices that a firm with significant market power can charge will not result in new entry, while the danger of chilling innovation and risk-taking does not arise as a legitimate concern.

The CAC in *Mittal* did not substantively engage in these debates but rather proposed the price in the 'long run competitive equilibrium' (LRCE) as the benchmark for economic value, while suggesting other assessments may have evidentiary value such as of investments made by the firm in expanding output. The LRCE benchmark obviously turns on how 'long run' and 'competitive equilibrium' are understood. On the one hand, SCI argued that it should be interpreted as the prices at which firms would enter the market without necessarily having access to the inputs at the costs of the incumbent. On the other hand, as the Commission argued, it should be understood as the pricing which would have prevailed had there been established effective competitors in the market with similar costs.

The interpretation of LRCE as the prices of an entrant appears to be an extreme position as other commentators though not agreeing on the exact interpretation of LRCE agree that it should be calculated with reference to existing firms. Calcagno and Walker (2010) understood LRCE to mean the costs of an efficient (not necessarily the most efficient) firm in the long run and proposed that economic value can then be calculated by means of a profitability test (tests used by the defendant in *Mittal*), where the efficient firm test refers either to the costs of the dominant firm or of a (existing) competitor. Davis (2011:328) held that when determining economic value in line with the conditions of LRCE, the assessment should consider among other things the dominant firm's production costs.

In addition to the issue about whether to take into account the costs of an entrant or those of notional established competitors, the LRCE approach also requires parameters to be specified in determining this equilibrium, and there could be multiple equilibria. Furthermore, a monopoly is a possible equilibrium if the hypothesized market is small relative to scale economies (such as if the existing market size is used in the case of a developing country with a relatively small demand).

We explore whether the LRCE approach takes us forward in the economic analysis of excessive prices by considering whether the reference to the competitive benchmark by the CAC was intended as an end or a means to an end. We argue that the appropriate approach is considering conditions of effective competitive rivalry where the outcomes would be cost-reflective prices where firms compete away pure profit and upstream advantages are passed on without discrimination against the local downstream industries.

The difficulties in the practical application of the LRCE approach is immediately evident in the SCI case in the treatment of firm-specific cost advantages (which it terms 'special cost advantages'). SCI's reading of the LRCE approach led it to discard the very favourable low input costs of feedstock propylene[2] in favour of hypothetical feedstock costs a notional entrant would face (which, in SCI's view, would be considerably higher than its own).

These low feedstock costs are as a result of a legacy of extensive former state support which bestowed SCI its market position. We assess in this paper why this approach is neither consistent with the realities of the South African economy nor with the purpose of the South African Act which has a strong focus on correcting previous excessive concentrations that resulted from state support.

This paper is structured as follows. Section 2 provides the South African legislative framework, a brief background to the relevant markets and the history of the case. Section 3 sets out the debates on the determination of economic value and the different interpretations of the CAC's definition of economic value in Mittal. Section 4 then deals with the treatment of special cost advantages and the importance of historic state support in excessive pricing case assessments. Section 5 provides some concluding remarks.

[2] Feedstock propylene is a key input into polypropylene and polymer production.

2. South African legislative framework and background to the SCI case

The formulation of excessive pricing in the South African Competition Act broadly follows that of European case law with the definition of an excessive price having been taken directly from the United Brands decision. Although the European legislation does not directly refer to excessive pricing, the term has been a product of case law (Lewis, 2011). Article 82(a) of the EC Treaty prohibits a dominant firm from, engaging in 'unfair' pricing practices, which has been interpreted as including excessive and predatory prices.

The South African legislations not only explicitly prohibits excessive pricing but has also included a definition of the term. The South African Competition Act provides that it is prohibited for a dominant firm to charge an excessive price to the detriment of consumers (Section 8(a)), where an excessive price is defined in s1(1)(ix) as a price for a good or service which bears no reasonable relation to the economic value of that good or service (aa); and is higher than the value (bb). The assessment that is set out in the Act comprises the factual determinations of (i) the price of the good or service that is alleged to be excessive and (ii) the economic value of that good or service and value judgements on the reasonableness of the difference between price and economic value as well as whether the price is to the detriment of consumers.

The act however, does not define economic value and this is the key area of debate in the South African case law. Economic value must be given interpretation in line with legislature's intentions including the kind of market conditions that the provision should be applied (Roberts, 2008 and Lewis 2011). The preamble of the South African Competition Act explicitly recognises the excessive concentrations of ownership and control, and the Act's purpose to address the consequences thereof, further reflected in the purpose of the Act. This includes restraining practices undermining a competitive economy, promoting employment, and ensuring small and medium enterprises have an equitable opportunity to participate in the economy. Addressing exploitative conduct by existing dominant firms in the form of excessive pricing, and not simply excluding possible entrants, is an important provision in the Act. Most other countries have not included this in their competition laws. The CAC in Mittal further noted that "*… a history of such state largesse cannot be permitted to subvert competition nor should the market power inherited from the erstwhile status as a state enterprise be exerted with continued impunity.*"[3] Thus, at least in the South African context the Competition authorities ought to be most concerned with pricing in markets with high and non-transitory barriers to entry i.e. where the dominant firm's position is entrenched, and where the dominant firm's position in that market is not the result of any innovation or risk-taking by the firm but rather to current or past exclusive or special rights.

There have been six cases dealing with excessive pricing in South Africa (Roberts, 2012). The main case, Harmony Gold v Mittal Steel SA was the subject of a Tribunal and CAC ruling, and has been written about extensively already (Roberts, 2008; Ezrachi and Gilo, 2009; Calcagno and Walker, 2010).

The other cases were settled and thus the competition authorities have not made a findings that can be assessed (See Roberts, 2012 for descriptions). As the first excessive pricing case

[3] *Mittal* (CAC) at [29]; see also Davis (2011).

with a ruling since the Mittal decisions, the SCI case presents an opportunity to revisit the old debates and engage new issues that arose.

The SCI Case

SCI, the respondent, is a wholly owned subsidiary of Sasol a previously state owned company that is a vertically integrated fuel and petrochemicals business. The complaint against SCI was on its pricing practices in the markets for purified propylene, where SCI has overwhelming dominance, and polypropylene, where SCI is dominant in terms of the Act but competes with Safripol (capacity constrained). South Africa, and Sasol, has been a net exporter of polypropylene for over 20 years.

The matter was referred to the Competition Tribunal (Tribunal) following an investigation into the polymers market by the Competition Commission upon request by the Department of Trade and Industry (DTI). The DTI was concerned about poor growth of labour-absorbing downstream industries, such as plastic product manufacturing, and high input pricing was identified as a major challenge to downstream beneficiation in the plastics value chain for household products such as buckets chairs, and industrial products such as motor car parts, and water tanks.

It was common cause between the parties that SCI is one of the lowest cost producers in the world with its main input cost around 25-30% lower than typical producers in Europe. Feedstock propylene, the main input required by SCI to make purified propylene and then polypropylene, is produced as a by-product from Sasol's Synfuels business (coal-to-fuel process).

Sasol's synthetic fuels business generates large volumes of propylene as a by-product. These are also much larger proportions of propylene than the typical oil refinery process. Sasol can, and does, convert some of the propylene into fuel, however, there are limitations on the extent to which it can do this cost-effectively. Propylene prices in other countries depend on its alternative uses, including keeping the feedstock (or refinery grade) propylene in the fuel pool, or extracting and purifying the propylene to chemical grade or polymer grade propylene for conversion into various chemical products and polypropylene. Sasol's pricing of polymer grade propylene does not reflect its actual alternatives, which are limited, given the large amounts of feedstock propylene that are produced as a by-product. Instead it has charged its polymer grade propylene at prices linked to the local polypropylene prices.

Sasol has based its feedstock propylene cost on its poor alternative of converting it into fuel According to an independent study in the mid-1990s done for the Liquid Fuels Industry Taskforce, low costs enabled Sasol's then JV with AECI, Polifin, to supply local buyers of polypropylene at prices in line with export prices (Arthur Andersen, 1995). At the time, import prices were around 36% higher than the domestic price (and more than this if imports were priced to take into account the 'hassle factor' of importing and overland transport costs).

SCI argued that its low cost feedstock is a 'special cost advantage'. Sasol acknowledges their very low cost advantage in propylene feedstock, which has underpinned expansions in capacity to serve export markets. The SCI case turns, in particular, on how the low costs of the respondent should be treated, especially where those low costs are derived from historical decisions which advantage the firm, in this case including policy decisions by the apartheid state.

While in the mid-1990s polypropylene to local customers was priced at export prices, Sasol soon moved to import parity levels, which it has maintained ever since. This meant a substantial increase in prices, which was followed by declining output of the local plastics industry. The costs of importing polypropylene into South Africa are not trivial, and included transport, financing, wharfage and a 10% import duty (although the duty has been reduced to zero). The price of both purified propylene and polypropylene, as intermediate products into plastics production, has significant implications on the price and competitiveness of domestic production of a range of plastic products.

The price charged by Sasol to local buyers of polypropylene has thus been very substantially above the prices earned on its exports, reflecting the inclusion of all the notional costs to import that have been charged by Sasol for product actually delivered from Secunda to local customers, concentrated in Gauteng. The price to local buyers competing in the domestic market has also been substantially above the prices Sasol has provided to other categories of customers, including those that qualify for export rebate under the Customer Export Incentive Programme.

The Tribunal found that economic value could be determined through different methods, an approach also consistent with the literature and the approach in other jurisdictions. It evaluated the following methods put forth by the parties to determine the economic value of purified propylene: price-cost tests; comparison of domestic prices with prices in other geographic markets; and, a comparison of SCI's export prices with domestic prices.

Ultimately the Tribunal found that the most robust test of price markups over economic value for purified propylene was the price-cost test. In other words, economic value could be proxied by costs of production. The Tribunal found that the markups over actual costs during the complaint period were in the range of 39.9 – 41.5% for Tier 2 (or second volume tranche) sales to Safripol and in the range of 25.1 – 26.5% for Tier 1 sales to Safripol. For the average of Tier 1 and Tier 2 prices, the Tribunal found a range of 31.5 – 33%.

SCI has appealed the case to the CAC, the matter was heard in December 2014 and the parties are awaiting the decision.

3. Determining Economic Value

The determination of economic value has been a point of contestation in excessive pricing literature and case law. As the legislation has not defined the term or established tests for its calculation, the case law has over time developed these tests. For example, there is a range of comparators that have been used in European cases (Motta and de Streel, 2006). These comparators have also been considered in the South African context can be grouped into two broad sets.[4] First, prices of the same firm for substantially the same product in different markets (after correcting for transport and related costs in the case of different geographic markets), and/or to different customers in the same market. This includes prices of product sold into export markets. Second, prices of the same/similar products in competitive markets, sold by different firms, such as international comparators.

Price-cost tests and profitability analyses have also used as a measure of economic value. However, before we try to measure economic we should first understanding what it is that we

[4] CAC *Mittal,* fn82

are trying to measure. Reviews of literature in this area have found that there is no generally accepted definition of economic value (Evans and Padilla, 2005; Calcagno and Walker, 2010). However, case precedents have been instructive in interpreting economic value. In United Brands, the courts defined economic value as the price that would arise under conditions of 'normal and sufficiently effective competition', while in NAPP economic value was understood to be determined under conditions of 'effective competitive pressure'. In light of these cases, excessive prices have been understood as those which could not be charged under conditions of effective competitive rivalry (Ezrachi and Gilo, 2009; Motta and de Streel, 2007). This however, takes us to the debate on the definition of effective competition. Effective competition is commonly understood as a process of rivalry, but it has also been defined as the absence of market power where market power is understood as the ability to raise prices above marginal cost in the short run and above average total cost in the long run (Mehta and Peeperkorn, 1999). In other words, a market can be said to have effective competition where there is sufficient rivalry to ensure that prices are not raised significantly above average total costs in the long run. This understanding is in line with Bishop and Walker (2010), who have argued that for levels of competition to be deemed effective regard should be had to the outcomes it produces rather than the form of competition.

The outcomes approach is the basis for the use of comparators in excessive pricing analyses as the comparator markets are chosen based on the outcomes in those markets. Where a market that has cost reflective prices would be regarded as having effective competition. In Europe, the United Brands, NAPP and Helsingborg cases used comparisons as benchmarks for economic value (See Calcagno and Walker (2010) for a review of European Cases).

Having established that the European case law, which our excessive pricing provisions are based on has interpreted economic value as the effective competitive rivalry we look at how the South African case law has interpreted this concept. We do not consider the Tribunal *Mittal* decision as the finding of excessive pricing in this case was determined without actually making a finding on economic value (See Calcagno and Walker, 2010; Lewis, 2009; Davis, 2011 and Roberts, 2008 for detailed discussions on the Tribunal's approach.

'Long-run competitive equilibrium': A framework or a new test?

The CAC in Mittal defined 'economic value' of a good or service as *"the notional price of the good or service under conditions of long-run competitive equilibrium".* This is not to be understood as a price set under conditions of perfect competition in the short run*, "but rather competition that would be effective enough in the long run to eliminate what economists refer to as 'pure profit'– that is a reward of any factor of production in excess of the long-run competitive norm which is relevant to that industry or branch of production."*[5] The interpretation of this one paragraph was debated extensively in the SCI Tribunal hearings with the cross examination of both experts lasting days. What is long run competitive equilibrium and what does it mean in relation to economic value?

In *SCI*, CAC paragraph 40 was interpreted as establishing two tests. A distinction was drawn between a test based on the price that would allow for entry (SCI's primary test), which determines the notional price of the good or service under assumed conditions of long run competitive equilibrium, and the cost of a competitor under a notional competitive norm

[5] CAC *Mittal*, para 40

(effective competitive rivalry test). Whether there is indeed a distinction between the LRCE test and effective competitive rivalry is dependent on the interpretation of the conditions of long run competitive equilibrium.

The 'long run' can be defined in a textbook sense as where factors of production are variable, where there is free entry and exit in an industry, and where normal profits, and not 'pure profit', are made (Blaug, 1997). Where, pure profit is to be understood as any profit above the 'normal' rate of profit, which includes depreciation and payment to shareholders. The normal rate of return rewards the investor at the opportunity cost of the investment. In economic textbook models of the "long-run" all factors of production are variable and firms can enter and exit. This, however, needs to take into account barriers to entry beyond simply making the necessary capital investment including, for example, access to key inputs. In SCI, the incumbent firm has access to low cost feedstock that is not available on equal to terms to potential entrants. This represents an absolute cost advantage in the sense that the entrant cannot secure as low a cost of production as the incumbent firm and as a result is a barrier to entry (see Bain, 1956, as cited in Gilbert, 1989).

At a return based on the opportunity cost of the investment the investor would be indifferent as to which industry they are in and would only have an incentive to invest in the relevant industry if the profits were above the normal rate. The CAC was also very clear that the meaning of LRCE is that there is zero 'pure profits'. The zero pure profits condition is at odds with the LRCE test which would require that there would be some profit above the normal rate to be able to attract entry. The LRCE test's understanding of the long run also means that the excessive prices would be temporary as entrants would compete the price down to the level of zero pure profits after entry. It is not consistent with durable entry barriers which are not necessarily specific to the firm – there could well be several firms with the same durable advantages over putative entrants. The idea of free entry and exit is rooted in a model which assumes away such barriers.

What is critical is to understand the role competitive equilibrium plays in determining economic value in the Competition Act, as the Act does not define economic value nor refers to competitive equilibrium. The equilibrium price resulting from competition is dependent on the market characteristics, even in the 'long run' where the size of the market and scale economies are still relevant. The LRCE test calculated with the actual conditions where excessive prices usually arise would be a quasi-monopoly (or, in theory, given that the dominance threshold is 35% or 45%, possibly a duopoly). However, for the CAC, an LRCE meant that the competing alternatives available to buyers mean that all supernormal/pure profits are competed away. By definition, this cannot include a monopoly as a LRCE, or, in the absence of restrictive assumptions, a duopoly. In fact, this interpretation of economic value may restrict the application in precisely the industries where market structure ensures the incumbent has a strong position as the facts of the market will mean a LRCE with positive economic profits.

It appears therefore that this conceptualisation of the LRCE test does not provide for a coherent analysis of economic value for an excessive pricing determination as suggested in the literature. It is necessary for the tests for economic value to have practical application. For a new test to take the debate forward then the said test should have less difficulties in application than the currently accepted tests for economic value. The LRCE test does not meet either of these criteria. It yields prices and hence economic values which are a function of the number of firms, the size of the market and assumptions as to how the firms compete.

In short, these are not prices which reflect pure profits having been competed away nor are they prices which are cost reflective.

The LRCE test divorces the test from the particular firm and circumstances. A reading of CAC Mittal in its entirety strongly suggests that the reference to LRCE was to provide a broad conceptual framework for the analysis of economic value and that it endorsed comparators and price cost analyses which are widely accepted measures of economic value. The appropriate approach to the reference to LRCE by the CAC is to consider what pricing would be under conditions of effective competitive rivalry between firms with similar costs to the incumbent. Thus the competitive equilibrium concept is a means to an end (effective competitive rivalry) and not an end. The Tribunal in *SCI* interpreted the reference to LRCE as the conceptual framework that should be applied when thinking through the assessment of economic value.[6]

We propose that the appropriate analysis is based on effective competitive rivalry, where the effective competition yields cost-reflective prices and the cost of a good or service is indicative of its economic value.[7] When thinking about the counterfactual to determine economic value you have to imagine a market that adds the dimension of effective rivalry to the industry under review using actual costs as a starting point. However, it is necessary to evaluate to what extent the dominant firm's accounting costs as reflected in their financial statements are representative of economic costs and to make adjustments where necessary. In other words, the price under long run competitive equilibrium is an outcome that can be expected where existing firms are competing effectively with each other and the costs of the dominant firm are indicative of the costs of the existing firms. This interpretation was accepted by the Tribunal in *SCI*, noting that in economic terms effective competition means rivalry between established firms in a given relevant market.[8] This is in line with Alfred Marshall's discussion of the fair or normal rate of profit for each branch of trade, under the "long period or true normal results of economic forces".

In relation to determining economic value of differentiated products Peterson et al (2008) argue that economic value of the product must first be determined by a method which assumes competition between producers of the identical product. That is, as if there had been competitors producing the same product rather than the actual situation where differentiation means firms produce variations of the product that differ materially (and a rival firm would have to invest in making its product a closer competitor to the dominant firm in question). However, this is not necessary where there is monopolistic competition as, per Chamberlin's model, in the long run monopolistic competition can produce perfectly competitive outcomes.

The implication of adopting effective competitive rivalry as the understanding of LRCE is that the thought exercise should be conducted on the costs of the existing firm, given that the existing firm could have been plausibly replicated (and not where the position was due to firm-specific innovation) and as a result the LRCE and effective competition tests will collapse into one test. There is no substantial difference between the two, rather the differentiation may be a gloss that is put on by economists. So the discussion on whose costs are relevant for the analysis are central to this debate. The notional entrant approach is also inconsistent with

[6] Tribunal *SCI*, para 50
[7] See CAC *Mittal*, para 51
[8] Tribunal *SCI* para 70

other areas of competition assessment that employ counter-factual analysis such as cartel damages and mergers. These also do not involve notional entrants, but rather counterfactuals based on the facts of the specific firms in question, in the market in question.

4. The treatment of special cost advantages

Central to the debate on what a competitive price would be is what the costs of production are. Although there are fundamental disagreements on the determination of economic value as described above, there is common recognition that the concept of economic value encapsulates cost considerations. The point of departure is of course on *whose* costs and *what* costs.

With regards to whose costs should be considered, the question is if it is the costs of the dominant firm in question, or that of a notional entrant, or costs which would prevail if there were effectively competing firms in the market. This was discussed in Section 3.

This section reviews the contrasting viewpoints of the parties in the SCI case on *what* costs should be considered. The key debate is whether all costs should be taken into account or certain costs be excluded on the basis that they are not representative of the 'notional competitive norm' or costs that the notional entrant would incur, because they confer a 'special cost advantage' to the particular firm in question. This debate emerges directly as a result of SCI's reading of LRCE.

We do not enter here into other debates raised in the case about the inclusion and exclusion of certain cost categories and the measurement of cost of capital. Although the latter dispute between the parties resulted in significant cost differences, the most fundamental dispute was on the treatment of special cost advantages and whether these should be excluded when determining economic value. The issue of the treatment of special cost advantages is core because it determines how SCI's low feedstock costs are accounted for in price-cost tests or profitability analyses. Given SCI's very low feedstock costs of propylene, price-cost tests taking into account these low feedstock costs result in high margins over costs.

Economic value in relation to costs

The CAC in Mittal held that the relevant costs can be calculated by determining the costs that would prevail in LRCE.[9] The CAC further held that while the dominant firm's costs are an important evidential ingredient in such an inquiry, they were not conclusive.[10] This is because some of the dominant firm's costs may be 'unique' to it, and not available to a notional entrant or existing competitor. By SCI's interpretation, these costs have to be adjusted upwards if they serve to reduce the dominant firm's costs below the notional competitive norm:

"[43] It seems to follow that, in determining the economic value of a good or service, the cost savings to the firm resulting from the subsidised loan or the lower than market rental – or indeed any other special advantage, current or historical, that serves to reduce the particular firm's costs below the notional competitive norm ought to be disregarded. Thus economic value is a notional objective competitive-market standard, and not one derived from

[9] Mittal (CAC) at fn 70
[10] Mittal (CAC) at fn 70

circumstances peculiar to the particular firm. If the firm's price is no higher than economic value, no contravention of s 8(a) can arise.'

The CAC however does not suggest that such special cost advantages ought to be completely disregarded in an excessive pricing assessment. In fact, para 43 goes on to state:

'If, however, the firm's price is in fact higher than economic value so determined, the test of reasonableness in respect of the difference remains to be applied. The expression 'reasonable profit' when dealing with economic value should be avoided. The test of reasonableness applies to the excess of price over economic value, and thus only to the element of 'pure profit' (over and above 'normal profit') implicit in that price. It is at this stage of the enquiry that circumstances peculiar to the particular dominant firm would rationally come into the reckoning (own emphasis).

What constitutes special cost advantages?

The CAC then gives certain broad examples of what might be considered a special cost advantage. It mentions benefits flowing to the firm from subsidised loans, long-term low rentals or other special advantage which may serve to reduce its own long-run average costs below the notional norm (para 43). But as the Tribunal highlights in the SCI decision, the CAC did not explain how the examples provided in the ruling arose from the particular facts of the Mittal case (para 90[11]). A number of things remains unclear - what exactly does a benefit from a subsidised loan and long-term low rental refer to and how would these be quantified in practice? If these advantages were available to more than one firm in the industry assuming there was competition, then would it still be a 'special' cost advantage? (See our debate on this point later). What other types of costs could be categorised as special cost advantages under this category and can the circumstances of the industry affect the consideration of a particular type of special cost advantage (that is, can a type of cost advantage that is special in one industry not be special in another)?

Furthermore, there is no indication of how such cost advantages could be 'corrected for' in an excessive pricing assessment. Sylvester (2014) demonstrates that the method of correcting for special cost advantages by simply adding costs onto those of the dominant firm's costs (to bring costs up to the notional competitive norm as suggested by Langbridge and Mackenzie, 2010) results in a number of distortions. He shows that this overestimates costs and prices that would result under a competitive market structure as well as possibly even overestimates the cost of the monopolist if it did not enjoy the special cost advantage at all.[12] Irrespective of whether the nature of the cost curve in such industries is upward or downward sloping, simply adding the 'special cost advantage' back onto the dominant firm's costs does not produce the appropriate counterfactual cost level (Sylvester, 2014). Considering special cost advantages when assessing reasonableness instead according to the latter part of para 43 in CAC *Mittal* avoids such challenges of adding back costs. The determination then reduces to a value judgement of whether the price-cost margins are justified given the source of the special cost advantages.

Sylvester (2014) also attempts to understand the possible meaning of special cost advantages and suggests that the *amici curiae* in the Mittal case appear to have conflated the notions of

[11] The Tribunal highlights that CAC didn't have to explain this as it remitted the matter to it.
[12] If certain assumptions of the shape of the cost curve are taken into consideration.

opportunity costs and costs that occur under the notional competitive norm. Sylvester highlights that the *amici curiae* explained at length why accounting and economic costs can differ if opportunity costs are present and that any special cost advantage should be valued at the opportunity cost rather than the actual amount paid. They then reach the conclusion that the CAC adopted in its decision at para 43, where, instead of using the wording 'opportunity cost' (following from their descriptions and reasoning) they use the wording 'notional competitive norm' as the standard to evaluate costs (Petersen et al, 2008: para 23.1 as cited in Sylvester, 2014). Sylvester's argument is that these are two different notions, and not just a matter of semantics. He argues that the opportunity cost is in fact a firm specific cost, while the notional competitive norm suggests a market related price which is not firm specific.

The Tribunal held that in the SCI case, given its specific circumstances, special cost advantages could not be assessed according to the general examples provided by the CAC in Mittal. Doing so would not take into account a situation where pure profit was not as a result of innovation and own risk taking (para 90). The latter was indeed the Commission's stance on special cost advantages.

It is crucial to understand the history of how SCI attained its dominant position and whether this was due to innovation and risk taking or whether it was bequeathed through extensive former state support. Only once this is understood can the treatment of special cost advantages be determined. The Commission led extensive evidence in this regard, including the various forms of state support received throughout the history of Sasol.[13] The Commission's expert witness highlighted that given the strategic nature of the sector, the state ensured that Sasol would not fail including through extensive protection of the fuel industry (which extended to marketing arrangement with other oil companies which ensured off take and marketing of Sasol's fuel); funding of Sasol through revenue from fuel levies;[14] support in terms of access to infrastructure; strategic inland location of Natref and exemption from paying crude oil transport costs etc. The state also bore much of the risk during the privatisation process. The Commission concluded that Sasol (which included SCI) was created and supported by the state and that any advantage that it presently enjoys is as a result of this and not as a result of innovation and own risk-taking. In turn, SCI's dominant position in purified propylene and polypropylene were as a result of such support. The Tribunal found in favour of the Commission in this regard,[15] highlighting that SCI's own witness confirmed that Sasol had leveraged its protected position in fuel to enter into the chemicals business.[16]

Special or not? What makes sense in the South African context?

SCI's fundamental dispute on this matter arose from its interpretation of CAC Mittal, categorising its low propylene feedstock cost as a special cost advantage which according to its interpretation of LRCE in CAC *Mittal* ought not to be considered in any calculations. SCI's position was that its Synfuels operations (using the Fischer Tropsch process) were unique and

[13] See Expert Witness statement of Dr Rustomjee, 2012, chief p3394 -5, p3399, p3400, p3403- 4m p3406

[14] Tribunal decision, para 106, drawing from evidence presented by Dr Rustomjee.

[15] Tribunal decision para 104- 108

[16] Tribunal decision para 116, citing Mr MacDougall of SCI: "*Sasol is establishing that it is using the Synfuels operation as a platform for growth. It is holding Synfuels neutral so that it is not making additional profit, but it is not losing anything and then that creates the opportunity to build a significant downstream petrochemical industry".*

could not easily be duplicated. The resultant low feedstock cost advantage conferred on SCI was therefore 'special'.

The Commission's industry expert witness argued that there was nothing special about the Fischer Tropsch process and that it was in fact a standard technology and production process. The Tribunal also held that SCI's witness conceded the purification process of SCI was not special in that it was not very different from USA producers in terms of costs, and was in fact a 'standard distillation technology'. The witness further conceded that SCI had undertaken limited innovation in purified propylene and polypropylene.[17]

More importantly, the Commission argued that the low feedstock cost that resulted from the process was not a 'unique' or 'firm-specific' advantage to SCI. If there was greater competition at the downstream level (in competition to SCI), then it would be expected that Synfuels would supply these firms with feedstock propylene (at prices that is supplies SCI) and it would not then be a 'unique' cost advantage to SCI only. In this sense, the lack of competition in the domestic market should not confer a special cost advantage to SCI (see also Sylvester, 2011, with regards to the facts of the Mittal case).

Furthermore, while SCI highly commended the CAC's approach in equating economic value to the *notional* price of the good or service under conditions of long-run competitive equilibrium, it strongly held that the CAC was mistaken in then suggesting (later in para 43) that any special advantage should be taken into account in considering the reasonableness of the relationship between the dominant firm's prices and economic value.[18] SCI's expert witness claimed that taking the special cost advantage back into the reckoning at this stage was nonsensical when it was removed in the first place as it did not represent the costs of a notional entrant.[19]

To not take into account special cost advantages at *any* stage of an excessive pricing enquiry appears entirely at odds with the purpose of Section 8 (a) of the Act in the context of the South Africa's history of economic development. The Act aims to ensure efficient outcomes in the economy, and in this sense, aims to achieve cost-reflective prices. But equally important in the South African context, the preamble of the Act clearly sets out the concerns arising from the previous economic and social imbalances of the economy, discussed in section 2.

The Tribunal concluded that SCI's cost advantage ought to be taken into account at some stage of the inquiry.,[20] The Tribunal noted that SCI's approach instead leads to an artificial result, and that it was not practical that if in SCI's notional exercise prices were found not to be above economic value, special cost advantages could never be considered ever again in the analysis. The Tribunal's interpretation of the CAC's decision was that a broader and more holistic view, which includes the realities of the market, must be taken when considering special cost advantages.[21]

The importance of history and how a firm attained its dominant position has further been recognised by Judge Davis (2011), noting that South Africa's past industrial policy did not

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[17] Tribunal decision para 111- 113, citing evidence from Mr MacDougall of SCI
[18] Mittal (CAC) at [43]
[19] Padilla cross examination at 2059, 14 – 2060, 9
[20] Tribunal para 120, 121
[21] Tribunal para 95

cater for competitive rivalry. Motta and de Streel (2007), Roberts (2008) and Evans (2009) also suggest that those markets in which monopolies established dominance due to current or past exclusive or special rights are the very markets in which competition authorities should be concerned about excessive pricing in the first place, as high prices are usually merely a rent unrelated to market conditions.

Given this manifest purpose of the Act, the widespread recognition that there are circumstances in which competition authorities should intervene in excessive pricing cases and the circumstances of this case closely fitting these criteria, SCI's views that special cost advantage should never be considered at any stage in an excessive pricing case is indeed entirely at odds. Never considering special cost advantages would vindicate exactly the types of firms whose conduct could potentially fall foul of this provision and where intervention should occur. These include present and former state-owned enterprises that attained their 'special cost advantage' not through innovation and own risk-taking but through state support.

Summary

Some general guidance on the treatment of special cost advantages can be drawn from the above discussion.

First, the history of how the firm attained its advantageous position is of fundamental importance in an excessive prices assessment. If it was through extensive innovation and own risk taking, then one could argue that the cost advantage that arises from this is indeed 'special' to the firm. In this regard, one could have regard, as the Tribunal did, to evidence or lack thereof on investments in technology in the affected business. The nature of the technology can also be evaluated as part of the broader argument. In this regard too, the Tribunal considered how unique the Fischer Tropsch technology really was. If the advantage is instead because of past and current state support, then this should not be considered special, because if a different industrial policy model was employed by the state at the time more than one firm could have potentially benefitted from such support. Under such circumstances, there is no way around using the dominant firm's own costs in price-cost and comparator tests.

Second, what may appear to be a 'unique' input cost to a downstream firm may not be unique to it at all if there was competition in the downstream market and every firm could potentially benefit from the low input in question.

5. Conclusions

Excessive pricing provisions are important for smaller markets (such as one finds in many developing countries) as economies of scale and barriers to entry imply a greater likelihood of dominant firms that are not subject to regulation and can charge supra-competitive prices. This is the case for the South African economy, which is characterised by concentrated industries and an economy skewed to resource-based and capital-intensive production due to previous exclusionary policies. In instances where the conduct is of an intermediary product, excessive pricing can be particularly harmful and the risk of over enforcement needs to be balanced against the needs of the economy and the harm from under-enforcement. In the SCI case the Tribunal held that the dominant firm's conduct has resulted in missed opportunities

for innovation and development for the domestic manufacture of downstream plastic goods. Considering the employment potential of a medium technology industry such as plastics conversion in a developing economy, South Africa cannot afford these missed opportunities.

Though there has been extensive debate on whether or not it is necessary for competition authorities to pursue excessive pricing, there is a growing number of articles that recognise that the substantial potential impact of an excessive price in an economy and, as such, have proposed that different jurisdictions should choose a path that is most appropriate for the particular circumstances. Otherwise in countries like South Africa where there is a history of concentrated industries particularly in upstream product markets, excessive prices will inhibit countries from changing the growth path of their economies. We note however, that it is important for authorities to consider the implications of making the type one or type two errors. False convictions can have the effect of chilling investments while false acquittals can inhibit growth of downstream industries. The growing consensus in the literature is that excessive prices should be limited to industries where there are high barriers to entry, the dominant firm has and can exercise its market power, and there is not significant innovation. Setting economic value at prices which cover high costs of entry (including higher input prices or poorer access to inputs) simply defines away the basis for the concern. Others have taken the argument further by identifying markets that are likely to allow a dominant firm to charge excessive prices. These are markets in which monopolies established dominance due to current or past exclusive or special right and high prices are usually merely reflect a supra-competitive rent (Motta and de Streel, 2007; Roberts, 2008; and Evans, 2009).

The controversies in excessive pricing are not limited to whether or not it should be pursued as an abuse of dominance but also encompass debates on the appropriate assessment thereof. Excessive pricing is one of the more difficult contraventions to prove given that one of the central concepts in its assessment is not defined in most jurisdictions. The accepted measures of assessing economic value include price-cost tests and comparators. The CAC *Mittal* definition of economic value would have been further elucidated in its application in the further evaluation the Tribunal was expected to do after the CAC remitted the matter back to it. Unfortunately the parties settled the matter before this happened and the issues were effectively left hanging. While SCI interpreted it as modelling the price that would allow for notional entrants we have understood it to be a counterfactual where there is effective competition. We considered whether long run competitive equilibrium as referred in CAC Mittal is a conceptual framework or a new test and found that the distinction that is made in the SCI case between effective competition and long run competitive equilibrium is artificial. Modelling notional entrants may result in a number of challenges some of which may lead to false acquittals. In such models equilibrium could be a monopoly if there are scale economies and a relatively small market and monopoly pricing against this benchmark would not be found to be excessive. This implies that excessive pricing could only be very short-term exploitation or only due to legal barriers to entry as the market would otherwise be effectively competitive. This approach is at odds with the circumstances of smaller economies like South Africa with concentrated industries with scale economies in steel and polymers. Also, multiple equilibria may exist and assumptions and judgments have to be made to determine competitive equilibrium.

Given that the purpose of the Competition Act in South Africa is economic efficiency, the CAC's reference to economic value as the notional prices under conditions of long run competitive equilibrium cannot be understood as modelling prices that would allow for notional

entrants, in circumstances where the market conditions do not allow for entry and the dominant firm is entrenched. The continued exertion of pricing power implies ongoing welfare losses and distortion of relative prices in the economy. We have argued that the appropriate interpretation of the CAC, which is also consistent with other passages in the decision, are prices that would arise under conditions of effective competitive rivalry.

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