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Excessive intervention?
Should competition authorities take on excessive pricing cases in markets with no barriers to entry?

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The European Union and many other jurisdictions have long considered excessive and unfair pricing a breach of abuse of dominance provisions of competition law. However, there have not been many cases, at least at the EU level. This reflects a general economic consensus that such intervention can often cause more harm than good, especially in markets where entry by competitors can be expected to sort out the problem. Recently, however, excessive pricing cases seem to be coming back into fashion, partly in reaction to public concern but also reflecting economic thinking that has questioned the consensus.

In particular, Professors Ezrachi and Gilo have together and separately published a series of papers arguing that entry is unlikely to correct high prices.[1] Professor Gilo (himself a former competition agency head) has recommended that competition authorities should make greater use of their powers to penalise excessive pricing – and that courts should compensate consumers who paid too much.[2] However, as we will demonstrate, the economic foundations for this belief are not strong enough to support such a radical extension of state control of prices.

Why high prices might not attract entry

It seems intuitively obvious that high prices will attract new competitors into an industry. If they do, then high prices will be self-correcting. Moreover, intervention to control pricing is unnecessary and could even be harmful, by deterring such entry.

However, Professors Ezrachi and Gilo rightly point to a logical flaw in this argument. A firm considering entry must consider how profitable the market will be not before, but after, it has entered. If this price is enough to reward the entrant for the costs and risks it undertakes, entry will occur; if not, then no entry will occur. Post-entry prices will be set by competition, so might be unaffected by the incumbent's initial price, in which case that price will not affect entry at all. Therefore, higher prices do not encourage entry, and government intervention is thus justified and need not deter entry, either.

The economic analysis is logical enough, but it is not enough in itself to justify the policy conclusion. It rests upon narrow assumptions about what information is conveyed by pricing, as well as an optimistic view of the ability of state institutions or courts to find the 'right' price.

Entry is likely to happen faster when prices are high

As a factual matter, high prices do seem to cause entry. Cartels fixing prices attract (and break down as a result of) entry, most famously in the case of OPEC. More broadly, studies of several industries have demonstrated that more profitable markets lead to faster entry and that incumbents sometimes engage in 'limit pricing': keeping prices down to deter entry.[3] One possible reason is that entrants might believe the incumbent's price conveys information about its cost. In these circumstances, lower prices can deter entry and 'excessive prices' would, conversely, attract entry.

More generally still, at a policy level it is common to assume that entry will respond to pricing signals. Competition authorities routinely clear mergers in industries with low barriers to entry, for example, on the presumption that entry would either discipline or correct high prices. This presumption seems justified: ex-post studies of merger decisions tend to show that entry responds to such opportunities.[4]

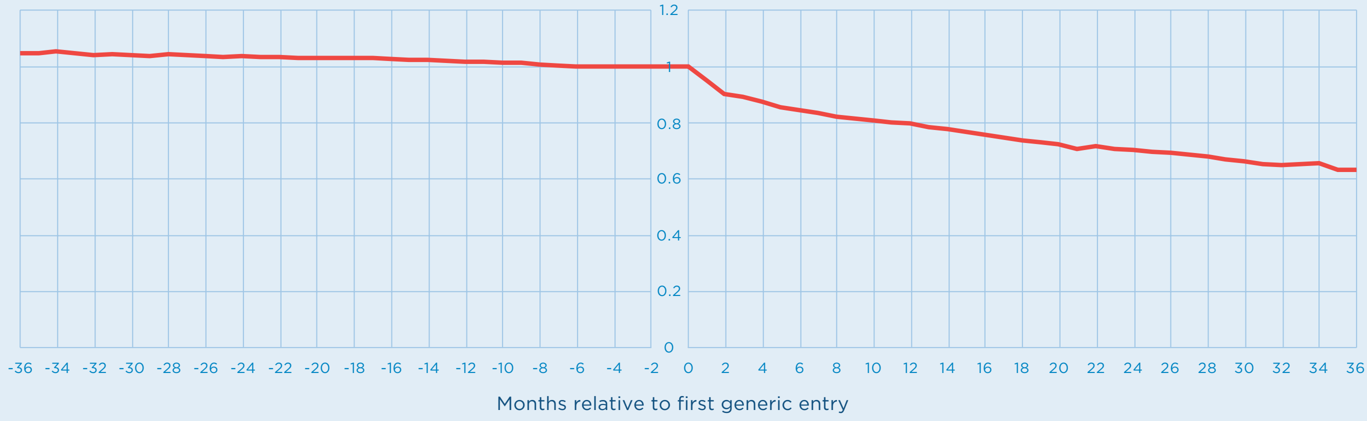
The simple intuition that high prices encourage entry seems, therefore, to be correct, even if the mechanisms by which it does so require more economic analysis than might be expected.

Markets are generally better than governments at setting prices

The flip-side of the argument that pre-entry prices are irrelevant is that government intervention to reduce excessive prices is reasonably harmless. If higher prices do not attract entry, then regulatory action to reduce prices will not deter or delay entry, as long as the price is not set so low as to make entry unprofitable.

All opinions expressed here are those of the authors, who are employees of Compass Lexecon. The authors, and other experts at Compass Lexecon, have advised several companies under investigation for excessive pricing under competition law, in the EU and elsewhere.

[1] See for example D. Gilo and A. Ezrachi (2008): "Are excessive prices really self-correcting?", Journal of Competition Law and Economics.
[2] D. Gilo (2018): "Excessive Pricing by Dominant Firms, Private Litigation, and the Existence of Alternative Products", in Frédéric Jenny Liber Amicorum, Concurrences.
[3] See, for example C. Gedge, J. Robert & A. Sweeting, (2013): "An empirical model of dynamic limit pricing: the airline industry". Working paper, University of Maryland and Duke University; or R. C. Seamans, (2013): "Threat of entry, asymmetric information, and pricing". Strategic Management Journal, 34(4), 426-444, for the cable industry.
[4] See for example: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/606693/entry-and-expansion-in-uk-ex-post-evaluation-kpmg.pdf



Note: Development of average price index for pharmaceutical products classed by 'International Non-proprietary name'
Source: European Commission 2009 sector inquiry on pharmaceuticals

The premise that any regulated price that provides a profit is harmless seems implausible. First, as we noted, there is indeed empirical evidence that higher prices attract entry. Second, faced with a single incumbent, entrants might race to be the second firm in a market and realise duopoly profits. The first entrant could do better still if the incumbent is expected to maintain its price, and sacrifice market share: a common pattern in generic pharmaceutical competition.[5] However, none of these incentives to race to be the first entrant will apply, if the incumbent's price has been reduced by a competition authority's intervention.

More generally, we have little faith in the ability of competition authorities and courts to find the 'right' price. In the authors' experience, people's confidence in their ability to decide that something is too expensive is inversely related to their expertise. Journalists and politicians are typically very confident; economists or accountants rightly less so. Prices are signals, without which the economy cannot function (as countries afflicted with general state control of prices, or hyperinflation, have discovered). The economy would not, in our view, be improved by more frequent price controls, or by firms setting prices under the constant threat of such controls.

If entry will occur, why not let it solve the problem?

One does not have to believe that excessive pricing necessarily encourages entry to think that the normal process of market entry is appropriate to deal with the excess. There are few plausible situations in which this would not occur and none of them justify intervention under competition law.

One possibility is that the dominant firm may be trying to prevent entry by threatening a price war involving prices below the long-run competitive equilibrium price.

However, such a threat will not be credible in most circumstances, because in most circumstances, incumbents would have no actual incentive to fight such a war once entry has taken place. In fact, the empirical evidence shows that price wars are not usually used by incumbents to block entry.

Another possibility is when normal competitive pricing post-entry would not enable the entrant to recover its investment cost. This is a well-recognised phenomenon in economics and it has a name: natural monopoly. There is also a well-recognised solution, at least when natural monopolies are large enough to be worth bothering about: ex-ante regulation (typically by a dedicated sectoral regulator). In most countries, governments do not rely on the threat of prosecution under competition law to deter natural monopolies from pricing above 'reasonable' levels, for good reason. So, in these circumstances too, competition law intervention is not warranted, although other forms of intervention might be (especially those that might bring down barriers to entry: turning a 'natural' monopoly into a competitive market).

Conclusion: caveat administrator

In AD 301, Emperor Diocletian published an edict fixing prices for well over one thousand products, across the Roman Empire. Despite being backed by sanctions that could effectively deter non-compliance (death), the edict was widely ignored and is believed to have contributed to Diocletian's fall from power. The reason is simple: finding the 'right' price is very difficult.

Recent research has rightly focused economists' minds on how and why high prices might be competed away by rivals. However, it would be an over-reaction simply to throw away the intuitive and empirically-supported finding that without entry barriers, unnecessarily high prices cannot be sustained. Markets do not always work, but when they do they are likely to find the right price more often than a civil servant or a judge would.

[5] See the European Commission 2009 sector inquiry on pharmaceuticals, for example: http://ec.europa.eu/competition/sectors/pharmaceuticals/inquiry/index.html

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